

Equalization and the Offshore Accords of 2005

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Abstract

The ad hoc Offshore Accords of 2005 have fundamentally altered the landscape of regional redistribution and Equalization in Canada for the foreseeable future. The fallout from the Accords has had an immediate impact on the functioning of the Equalization Program and the political factors that inform debate over future reforms. Given the far-reaching implications of these extra-formula arrangements, one must examine the circumstances that led to their signing. To this end, this thesis examines the positions, process and politics that ultimately resulted in the February 2005 Newfoundland and Nova Scotia Offshore Accords. The major part of this thesis will compare the case of Saskatchewan to the cases of Newfoundland and Nova Scotia.

Like Newfoundland and Nova Scotia, Saskatchewan has made a bid for an Energy Accord that will protect the province's energy revenues from the Equalization clawback. However, Saskatchewan has been unsuccessful at reaching a bilateral agreement with the federal government. Several major factors prevented Saskatchewan from receiving an Energy Accord. First, its position has been less consistent than those of Newfoundland and Nova Scotia. Saskatchewan has frequently adopted new positions based on pragmatism in order to maximize a possible Equalization deal. Second, Saskatchewan faced an unfavourable political environment. While Newfoundland and Nova Scotia's federal electoral seats were critical for the Liberal Government in the 2004 federal election, Saskatchewan offered little in the way of political gain for Ottawa. Moreover, once the 2005 Offshore Accords were signed, the rest of the country grew hostile to extra-formula deals, and thus, was not receptive to a Saskatchewan Energy Accord.

Perhaps the most important finding concerned the long term implications that the 2005 Offshore Accords will have on the credibility and effectiveness of the Equalization Program. The Accords undermined the traditional processes, and have opened a possible *Pandora's Box* of ad hoc politically-motivated fiscal arrangements.

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Chapter 1: *Introduction*

1. Why Equalize?

The Equalization Program is a product of Canadian federalism. In unitary systems, the central government has the ability to provide uniform public services and comparable rates of taxation for all regions in the country. The Canadian Constitution assigns the provinces many spending responsibilities including health, education, and other social services. However, economic capacities among provinces vary considerably. Consequently, provinces will be unable to provide equal levels of public services under equal taxation rates.¹

If provincial fiscal disparities remain uncorrected, *net fiscal benefits* (NFBs) differentials will emerge among provinces. NFB is the difference between the value of public services received and the taxes paid by an individual residing in a particular province. Differential NFBs create several problems. First, NFB disparity can lead to increased migration. People have an incentive to move away from regions with lower NFB to provinces with higher NFB. The outflow of people can further stunt economic growth of a province and increase the gap among NFBs.² Second, unequal NFBs raise issues of fairness and equity. Canadians should be entitled to a basic level of public services under a reasonable taxation load notwithstanding where in the country they choose to reside. The Equalization Program is a policy instrument designed to reduce the disparities among provincial NFBs.

In 1982, the Canadian commitment to Equalization became entrenched in the Constitution. Section 36 of the *Constitution Act, 1982* states:

- (1) Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments are committed to
 - (a) promoting equal opportunities for the well-being of Canadians;
 - (b) furthering economic development to reduce disparity in opportunities; and
 - (c) providing essential public services of reasonable quality to all Canadians
- (2) Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.³

In the narrowest sense, the Constitution commits Canadian governments to ensuring comparable services levels could be provided under comparable taxation burdens (Section 36 (2)). However, Section 36 (1) expands the concept of Equalization to include the idea of regional opportunity and social citizenship. Arguably the broader interpretation of 36(1) could be used to justify bilateral extra-formula Equalization agreements such the Offshore Accords between the federal government and both Newfoundland and Nova Scotia (to be examined in Chapter 3).

The Canadian commitment was reflected in the May 2006 report issued by the Expert panel on Equalization and Territorial Formula Financing. The O'Brien report describes Equalization as "the heart of Canada's federation.... In many ways, Equalization reflects a strong Canadian commitment to fairness. It has been described as the glue that holds our federation together."⁴ However, in spite of the wide recognition of the necessity of Equalization, little consensus exists as to the specifics of the Equalization formula. As the O'Brien reports suggests "the saying 'the devil is in the details certainly rings true for Equalization.'"⁵

Equalization entitlements are determined by formula. The formula uses 33 revenue sources to measure the fiscal capacity of every province and determines the

appropriate Equalization transfer. Among the most controversial aspects of Equalization is the treatment of natural resources in the Equalization formula used to redistribute federal resources to “have not” provinces. There are several reasons why natural resources have become a focal point for Equalization. First, natural resources are a significant source of interprovincial economic disparities in Canada. Second, the unpredictable and highly volatile resource revenues create problems of instability and affordability in the Equalization Program. Fluctuating international prices for resources lead to large fluctuations of resource revenue entering the formula. This translates into unpredictable and highly erratic Equalization transfers. Not every province is endowed with the same natural resources. Higher resource prices will lead to larger Equalization transfers to some provinces. Thus, the overall cost of the Equalization Program increases causing problems of affordability. In addition, proposals that suggest altering the aspects of the Equalization Program that affect natural resources will have very different financial impacts on various provinces.⁶ The contentious nature of natural resources and Equalization (to be further examined in Chapter 2) has played a determinative role in the historic evolution of the Equalization Program.

2. Origins and Evolution of Equalization in Canada

In the broadest sense, the informal practice of Equalization dates back to a series of post-Confederation federal grants and subsidies that were designed to offer more financial assistance to the Maritime Provinces than to Quebec and Ontario.⁷ Continuing into the 1930s the federal transfers were intended—though not explicitly—to top off the

fiscal capacities of the Maritimes so that these provinces could provide similar levels of public services and taxation as those of central Canada.⁸

In 1927, the Rowell Sirois Royal Commission on Dominion-Provincial Relations articulated, for the first time, a need for a formalized Canadian system of Equalization. The Rowell Sirois report called for the implementation of National Adjustment Grants. The grants were to be, in fact, Equalization payments with the goal of achieving “average standards of services in every province.” The National Adjustment Grants were to be reviewed every five years so as to be adjusted to meet changing provincial needs.⁹

In spite of the Rowell Sirois recommendations, the formal Equalization Program was not created until 1957. Originally, the program used a top-two province standard. That is, the fiscal capacities of the two richest provinces were taken as the basis for Equalization. In practice, the standard provided payments so that recipient provinces had revenues that equalled the average of the fiscal capacities of Ontario and British Columbia. As a consequence, the top-two province standard ensured nine out of ten provinces would be entitled to an Equalization transfer (because one of the two provinces in the standard would also receive Equalization).

Since 1957, the Equalization Program has been renewed and amended at regular five-year intervals. Notable trends underlie all major formula alterations that have occurred between then and today. First, most significant amendments have been efforts to control the overall cost of the program. Second, as a result of cost-control efforts, most alterations have dealt with the treatment of natural resources in the Equalization formula because the dramatic price spikes of these revenues lead to higher Equalization payouts. Today, 14 out of 33 revenue sources measured in Equalization refer to natural

resources. As a result, natural resource revenue has created problems of unsustainable costs, unpredictability, and instability for the Equalization Program. Most of the several notable changes to the Equalization formula since 1957 involve natural resources.

The amendments in 1962-1967 included the reduction of the natural resource inclusion rate from 100 percent to 50 percent. In addition, the top-two province standard was replaced by a ten-province standard. These amendments were largely in response to resource-rich Alberta becoming a “have not” province, i.e., a recipient of Equalization.¹⁰

The next significant amendment to Equalization came in 1967. The *Fiscal Arrangements Act* of 1967 introduced the Representative Taxation System (RTS) formula. All provincial revenues (16 revenue sources in total) entered. In order to determine an Equalization entitlement, the national average tax rate was calculated for each revenue source. This average tax rate was then applied to each province’s revenue sources. If the province was determined to have a revenue-raising capacity that surpassed the national average, it would not receive Equalization transfers. If, however, the province’s revenue-raising capacity were below the national average, then it would receive Equalization. The 1967 amendments also reinstated a 100 percent inclusion rate for natural resources.

In 1972 and 1973 the international price of oil increased sharply. In response to growing Equalization costs, the federal government altered the scheme for equalizing energy revenue. In 1974 Ottawa introduced an amendment that effectively distinguished between basic revenues (not attributed to the international energy disturbance) and “artificial” revenues (directly attributed to inflated global market prices). Basic energy revenues were no longer equalized in full.

The *Fiscal Arrangements Act* of 1977 again altered the treatment of natural resources. The proportion of non-renewable resource revenues that entered the formula was changed to 50 percent. Moreover, the proportion of total Equalization costs derived from resource revenues was capped to one-third of the entire program costs. This provision is referred to as the “natural resource override.” However, natural resources continued to cause problems. Due to the high prices of oil and natural gas, Ontario qualified as a “have not” province for each year between 1977 and 1982. In response, the federal government introduced the “Personal Income Override” in 1981. The so-called “Ontario Ceiling” disqualified any province from Equalization entitlements if the provincial personal income per capita exceeded the national average. This provision only affected Ontario.

The 1982 amendments marked the last major revamping of the Equalization formula to date. In efforts to control the costs of the program, the ten-province standard was replaced by a five-province standard (FPS). Alberta’s energy revenues were driving the ten-province standard up. In order to reduce the overall cost of the program, the federal government eliminated the income from the province with the greatest fiscal capacity, i.e, Alberta. The amendment was balanced by the elimination of the provinces with the lowest fiscal capacity (Newfoundland and Labrador, Nova Scotia, Prince Edward Island, and New Brunswick). The five “middle” provinces remain in the standard: Quebec, Ontario, Manitoba, Saskatchewan, and British Columbia.

The basic structure of the 1982 Equalization Program has not changed. The RTS-FPS program has now been expanded to include 33 revenue sources. For each revenue source, a national average tax rate is calculated. The standard is determined by applying

this national tax rate for a particular revenue source to the average per capita revenue in the five standard provinces. In order to determine the Equalization entitlement, the national average tax rate is applied to the province's own per capita tax base for that source. If the entitlement is negative, the province is a "have" province for that particular revenue source. If the entitlement is positive, then the province is a "have not" for the revenue source. Most provinces will possess both "have" and "have not" revenue sources. Even Alberta—which has the largest negative entitlement—is determined to be a "have not" province with respect to some of the 33 revenue sources. In order to determine the final Equalization transfer, each province's 33 negative and positive entitlements are added together. If the aggregate is positive, the province is a "have not" province and will receive an Equalization payment. If the aggregate is negative, the province is a "have" province and gets nothing. It is important to note that the Canadian Equalization Program equalizes "up" but it does not equalize "down." That is to say that if a province is determined to be a "have" province, it is not required to make a direct payment into the program.

The Equalization Program is funded by the federal government. Federal tax dollars are used to finance transfers. However, some provinces—especially "have provinces"—point out that Equalization is indirectly funded on the backs of "have provinces." This argument, as advocated by Ontario Premier Dalton McGuinty, points out that "have not" provinces recuperate a portion of their tax monies through Equalization transfers. Conversely, when residents of "have" provinces pay taxes to the federal government, none of the revenue is returned by way of the Equalization Program.

As a result, “have” provinces have a vested interest in containing the overall cost of the program.¹¹

The operation of Canada’s Equalization Program creates a phenomenon referred to as a “clawback.” When a province experiences an increase in revenue from one of the 33 sources, its fiscal capacity according to the Equalization formula will increase. Therefore, the Program will decrease the province’s Equalization entitlement by an amount that corresponds to the increase. The amount of the decrease in Equalization entitlements is the Equalization clawback. The clawback of natural resources is the subject of the subsequent case studies.

3. Process

The Equalization Program has been renewed every five years since its creation in 1957. The negotiation process begins immediately following the previous renewal, and participants include various permutations of bureaucrats, cabinet members, and sometimes First Ministers. While the process is generally inclusive in the sense that all provinces have the opportunity to make suggestions and present a case for amendments, ultimately, the decision is always made by the federal government.

There have been two marked aberrations from the five-year renewal process. The first occurred in 1985 and 1986 when Newfoundland and Nova Scotia signed the bilateral Atlantic Accords with the federal government. These Accords afforded the two provinces special provisions pertaining to their offshore oil revenue. The Atlantic Accords will be discussed in greater detail in Chapter 3. The second occurred in 2005 when these same provinces signed renewed agreements on offshore oil with Ottawa.

These agreements entitled, *Arrangement Between the Government of Canada and the Government of Newfoundland and Labrador on Offshore Revenues* and the *Arrangement Between the Government of Canada and the Government of Nova Scotia on Offshore Revenues*, were signed in February 2005. The treatment of Newfoundland and Nova Scotia energy resources marks a significant departure from traditional Equalization practices. Throughout the tumultuous history of natural resources in the Equalization formula, most of the changes occurred within the traditional five-year review process. However, the new Offshore Accords were negotiated and signed outside of the Equalization renewal process which terminated with the amendments of 2004. Furthermore, both the 1985 and 1986 Atlantic Accords and the 2005 Offshore Accords were negotiated with only two provinces, outside of the normal review process.

4. Focus and Objectives

The ad hoc Offshore Accords of 2005 have fundamentally altered the landscape of regional redistribution and Equalization in Canada for the foreseeable future. The fallout from the Accords has had an immediate impact on the functioning of the Equalization Program and the political factors that inform debate over future reforms. Given the far-reaching implications of these extra-formula arrangements, one must examine the circumstances that led to their signing. To this end, this thesis will examine the positions, process and politics that ultimately resulted in the February 2005 Newfoundland and Nova Scotia Offshore Accords. The major part of this thesis will compare the case of Saskatchewan to the cases of Newfoundland and Nova Scotia. The first objective of these case studies is to determine how these cases depart from the traditional principles of

Equalization. Like Newfoundland and Nova Scotia, Saskatchewan has made a bid for an Energy Accord that will protect the province's energy revenues from the Equalization clawback. However, unlike Newfoundland and Nova Scotia, Saskatchewan has been unsuccessful at reaching a bilateral agreement with the federal government. The second objective of the thesis is to discover what factors led to Newfoundland's and Nova Scotia's success and Saskatchewan's failure. Again, the Saskatchewan case will highlight the positions of the participants, process of negotiations, and the political motivations to discover the key events and circumstances that influenced the unsuccessful outcome for Saskatchewan.

5. Methodology and Organizational Structure

This thesis uses the case study method to highlight key issues and problems with the modern configuration of the Equalization Program. The cases have been informed primarily by journal articles, government-initiated studies, government documents, and newspapers. Interviews with government officials provide additional information about facts that were not in the public domain.

This thesis looks at three major elements in the cases of Newfoundland, Nova Scotia and Saskatchewan. The first focus is positions. The negotiating positions of each of the provinces, as well as the federal government will be explained and analyzed. The second aspect is process. The thesis will examine the process of negotiations that led to the Offshore Accords for Newfoundland and Nova Scotia, and the process which failed to deliver an energy accord for Saskatchewan. The third focus will be on the politics that

affected each case. There were clearly many political factors that influenced the provincial and the federal governments.

Chapter 2, *Natural Resources and Equalization*, looks at the problem of the Equalization clawback as it pertains to natural resources. These issues provide the foundation for the Newfoundland and Nova Scotia Accords, and the Saskatchewan argument for its own Accord.

Chapter 3, *The Cases of Newfoundland and Nova Scotia*, looks at the specific factors that led to the 2005 Offshore Accords. The chapter examines the positions of Newfoundland, Nova Scotia, and Ottawa. It also deals with the bilateral and ad hoc process that led to the signing of the Offshore Accords. Finally, the chapter will discuss some of the political factors that motivated the actors determined the outcomes.

Chapter 4, *The Case of Saskatchewan*, looks at the case of Saskatchewan. Like Newfoundland and Nova Scotia, Saskatchewan has a history of grievances concerning the treatment of its energy revenues in the Equalization formula. This chapter examines the positions of Saskatchewan and the federal government; the process through which negotiations occurred; and the political factors that influenced the negotiations. Chapter 4 concludes with observations about the general differences between the Saskatchewan case and the Newfoundland and Nova Scotia cases.

The final chapter, *Conclusion*, broadens the analysis to consider the overall Equalization Program. It will examine the possible long term implications that arise out of the two cases. It will also make recommend a prescription for reform of the Equalization Program.

Chapter 2: *Natural Resources and Equalization*

Since the creation of the modern Equalization Program in 1957, natural resources revenues have consistently proven to be the most contentious program issue. The treatment of resource revenues has been the source of the majority of major amendments and remodeling that affected Equalization over the last five decades. Rising oil prices and increasing oil revenue have accentuated the problems of Equalization and natural resources; particularly for Newfoundland, Nova Scotia, and Saskatchewan.¹² Indeed, it is the issue of natural resources that has created the current Equalization energy controversy. The Newfoundland and Nova Scotia offshore agreements emanate directly from the perpetual struggle between natural resource rents and Equalization entitlements. In the energy agreements, Newfoundland and Nova Scotia managed to increase their share of the net profits from offshore revenue after Equalization has been calculated. Saskatchewan is pursuing a similar arrangement.

In order to understand the context of the current energy revenue disputes, it is important to understand why natural resources create controversy in the Equalization Program. If natural resources are to be treated differently than other provincial revenue sources, which has often been the case over the history of Equalization, the nature of these revenues must be unique. This chapter explores the proposition that natural resources are indeed different from other revenues. The explanation focuses specifically on nonrenewable natural resources. The contemporary debate involves four major factors: the clawback, ownership, asset liquidation, and incentives. These factors are the base on which the governments of Newfoundland, Nova Scotia and Saskatchewan make their claims for special treatment of energy revenue in the Equalization formula.

1. The Clawback

Many of the problems caused by natural resources originate in the clawback phenomenon. The clawback is a phenomenon relevant to the 33 tax bases used in the Equalization formula. The calculation employs a Representative Taxation System (RTS) to determine the fiscal capacity of each province. The RTS calculates each of the 10 provinces' potential revenue from 33 revenue sources. Once a province's revenue raising capacity is measured, it is compared to the national standard. Currently, Equalization uses a Five-Province Standard (FPS), which relies on the average fiscal capacities of British Columbia, Saskatchewan, Manitoba, Ontario, and Quebec to determine the national standard.¹³ For each tax base the province's revenue potential is measured against the FPS. If the province's taxation capacity exceeds the FPS, the province is a "have" province for that particular revenue base. Conversely, if the taxation capacity is below the FPS, the province is a "have-not" province for that revenue base. When the cumulative revenue-raising capacity for all 33 tax bases falls below the FPS, the overall, the province is a "have not" province and receives Equalization transfers to "top off" provincial capacity to the standard.

One of the most important consequences of using a RTS formula-based approach¹⁴ is the clawback effect. When government income from a revenue category increases, a "have not" province gains new revenue, and its fiscal capacity will increase. Because the province then enjoys a larger fiscal capacity, it moves closer to the standard. Therefore, every new dollar raised by a province will decrease the province's overall Equalization entitlement. Due to the clawback, for a "have not" province, new revenue often results in little or no new money in provincial coffers.

The clawback is only a problem for “have not” provinces and those that are just above the “have” line. The clawback is of little concern for provinces that comfortably exceed the “have” threshold because these provinces do not receive Equalization transfers. The clawback is resented by the affected provinces. These provinces find themselves in a situation where significant economic growth does not lead to real revenue growth.

While the clawback is imposed on all 33 tax bases, “have not” provinces particularly resent its impact on nonrenewable natural resources. These provinces assert that these resource rents are somehow special, therefore they should not be subject to the clawback. The rest of the chapter will explore the relationship between the clawback and nonrenewable natural resources.

1.1 Generic Solution

The federal government introduced the Generic Solution in 1994 in an attempt to deal with some of the undesirable consequences of the clawback. The federal government cites the potential for provinces to manipulate their taxation policies as the reason for the Generic Solution. Because Equalization is calculated according to the average national tax rates of all 10 provinces, entitlements directly relate to changes in the national taxation averages. Under most circumstances, when a province changes its tax rates, no significant movement in the national average will occur. However, when a particular tax base is concentrated within one province only, this province can significantly affect the national standard. In fact, in some instances when a province possesses the entire tax base, its own tax rate will be the lone determinant of the national standard. In these circumstances, one province’s taxation choices can significantly

distort the entire Equalization calculation of a particular revenue source. Moreover, a province may choose inefficient taxation policies in order to maximize its Equalization transfer.¹⁵ For example, if a province arbitrarily lowers the national average by setting its tax rates too low, it will minimize its clawback at no short-term cost to provincial revenue after the clawback.¹⁶

In order to reduce negative taxation incentives, the Generic Solution reduces the clawback for those provinces that possess more than 70 percent of the national tax base. For the qualifying provinces, the clawback of the affected tax base is reduced to 70 percent of the provincial revenue. Therefore, the province is always guaranteed to retain 30 percent of its revenue after the clawback. Because the province will still keep a portion of its revenue, it will have increased incentive to introduce economically efficient taxation policies on the base in order to maximize net provincial revenue.

In practice, the Generic Solution has two arbitrary effects. The first problem is that Ottawa has the discretion to create, combine, and eliminate tax bases. For example, when Ottawa created a separate category for offshore oil it allowed Newfoundland's energy revenue to qualify for the Generic Solution. Likewise, when Ottawa combined potash into a new category for minerals in general, it disqualified Saskatchewan's potash revenue from the Generic Solution. Provincial clawback relief is completely subject to the will of the federal government.¹⁷

The second arbitrary effect of the Generic Solution is the inconsistency in the calculation process. While the Equalization entitlements and clawbacks are determined using a five province base, eligibility for the generic solution is determined using all ten provinces. This discrepancy creates some arbitrary and unfavorable consequences for

provinces that are members of the FPS. This incongruity is explored in Chapter 4 in discussing Saskatchewan's energy revenues.¹⁸

1.2 Atlantic Accords of 1985 and 1986

Like the Generic Solution, the 1985 and 1986 Atlantic Accords reduce clawbacks for Newfoundland and Nova Scotia. However, while in principle the Generic Solution deals with all 33 revenue sources, the Atlantic Accords are limited to offshore oil. The Atlantic Accords consist of two bilateral agreements between the federal government and each of Newfoundland and Nova Scotia. The Accords were not exclusively concerned with Equalization. They involved jurisdictional and administrative arrangements for the exploitation of offshore oil fields.¹⁹ The Newfoundland Offshore Accord and the Nova Scotia Offshore Accord were signed in 1985 and 1986 respectively.

The stated purpose of the Accords was to provide transitional protection from the clawback and allow offshore development. The clawback protection lasted 12 years for Newfoundland and 10 years for Nova Scotia. The Accords consisted of two main components. The first provision was an offset floor, which guaranteed the two provinces a certain percentage of their Equalization transfer from the previous year. That percentage was 95, 90, or 80 percent, depending on the provincial fiscal capacity relative to other provinces. The second component was a phase-out process. The phase-out process allowed the clawback to be reduced by declining percentages over the existence of the Accord (12 years in Newfoundland and 10 years in Nova Scotia).²⁰

In terms of the Equalization of natural resources, the Atlantic Accords contain three notable implications. Firstly, Equalization agreements were made bilaterally, and outside of the regular renegotiation process. The negotiation involved only two parties;

Ottawa-Newfoundland in one case and Ottawa-Nova Scotia in the other, at the exclusion of all other provinces and territories. This kind of bilateral process was unprecedented under the Equalization program. Secondly, the very existence of the Accords conceded that nonrenewable resource revenues, at least offshore oil, warrant special treatment. Thirdly, the Accords set a precedent for extra-formula amendments to the Equalization program. Prior to the 1980s, most major changes in the program occurred within the context of multilateral formula adjustments. The Atlantic Accords, however, modify Equalization entitlements outside of the formula.

2. Provincial Ownership

The continued existence of a confiscatory clawback creates other objections to the Equalization framework of natural resources. One of the most common objections falls under jurisdictional terms. Section 92 (2) *Constitution Act, 1982* reaffirms provincial ownership of natural resources. Furthermore Section 125 states that two levels of government cannot tax the other's lands or property. Therefore, some argue that the Constitution forbids the federal government from taxing provincially owned resources. Proponents of this argument reason that the Equalization clawback effectively constitutes a backdoor tax on provincial resource revenues. Therefore, the argument reasons that any resource clawback is unconstitutional.

The Constitution, however, also contains provisions that complicate the jurisdiction arguments. Section 36 of the *Constitution Act 1982* assigns to the federal government the responsibility of Equalization of provincial revenues. The obvious clash between Section 125²¹ and Section 36 demands compromise.²² The essential question is

can the federal government infringe on provincial jurisdiction (natural resources) when the greater national good is at stake.

The limits of provincial ownership rights and jurisdiction of taxation of Section 92 have been twice tested by the Supreme Court. The first case, *Canadian Industrial Oil and Gas Ltd. (CIGOL) v. The Government of Saskatchewan et al. (1977)*, challenged Saskatchewan's then existing taxation structure, designed to capture the new resource rents caused by a spike in international oil prices. The government of Canada intervened on the side of CIGOL, in an attempt to limit provincial jurisdiction concerning natural resources that are intended for sale inter-provincially or internationally. The Court declared Saskatchewan's actions *ultra vires* on the grounds that (1) the actions constituted indirect taxation and were therefore violating Section 92, and (2) the actions affected interprovincial trade and therefore infringed on federal jurisdiction. In a 7-2 decision the Supreme Court ruled on behalf of CIGOL, implying that Saskatchewan's ownership to oil rents was limited by virtue of Section 92 (2), trade and commerce.²³

The next case that restricted the reach of Section 92 is *Central Canadian Potash Corp. (CCPC) v. the Government of Saskatchewan*. Central Canadian Potash Corp challenged the Saskatchewan government's pro-rationing scheme that fixed the price of potash. Viewing the case to be of significant importance, the government Canada took the unprecedented initiative of applying for co-plaintiff status. Again the Supreme Court ruled against Saskatchewan. While the provinces retain ownership over their resources, they are limited in what they do with these possessions.

The net effect of *CIGOL* and *CCPC* is that provincial ownership over natural resources can be limited by a variety of external factors. The court cases allowed Ottawa

to assume natural resource jurisdiction under Sections 91 and 92 (2), trade and commerce. These limitations open possibilities to further limitations to provincial ownership rights for the national interest, i.e. Equalization.

The controversy and provincial resentment resulting from *CIGOL* and *CCPC* led to the further clarification of provincial resource ownership and jurisdictional rights in the 1981 round of constitutional negotiations. The result was Section 92(A).²⁴ This section provides for provincial jurisdiction in the exploration, development, and conservation of natural resources. However, Section 92(A) favors federal government involvement in the resource sectors:

Nothing in subsection (2) derogates from the authority of Parliament to enact laws in relation to the matters referred to in that subsection and, where such a law of Parliament and a law of a province conflict, the law of Parliament prevails to the extent of the conflict.²⁵

The addition of Section 92(A) did little to enforce provincial ownership rights. In fact, the section appears to have opened the door to other cases of indirect federal dipping into resource rents. The strengths and limitations of 92(A) have yet to be challenged at the Supreme Court level.

In light of the apparent limitations of 92(A) it is possible to argue that provincial ownership rights do not prevent indirect federal taxation through Equalization clawbacks. Robin Boadway argues that the principles of Section 36 take precedence over provincial ownership rights. Nothing in Sections 92 or 125 expressly assigns resource rents to the provinces. Furthermore, the historic understanding of the nature of Equalization necessitates the surrender of some ownership rights. Therefore, Boadway concludes that the Equalization commitments in 36(2) trump ownership entitlements.²⁶ While

Boadway's conclusion in the paramountcy of Section 36 has yet to be tested in court, the legacy of *CIGOL* and *CCPC* certainly weakens the provincial ownership argument.

3. Development of an Asset

When the natural resource in question is nonrenewable, provincial ownership issues become more complex. Ken Boessenkool and the Atlantic Institute for Market Studies (AIMS) argue that the sale of a non-renewable resource is like converting a provincial asset. Collecting royalties from a non-renewable resource is unlike other revenue collection. The transaction simply converts a physical asset to a financial asset. Nonrenewable resource royalties are not a rent; they are only the liquidation of an asset that the province has possessed since it was created.²⁷ Nonrenewable resource revenues are one-time in nature, and therefore the owners of the asset must retain those profits. Because the Constitution assigns resources as a provincial domain, the provinces should be able to keep all of the rent from the sale of nonrenewable natural resources.²⁸

Boadway adamantly refutes this argument. He bases his argument on the premise that nonrenewable resources are located in particular provinces by virtue of chance alone. Therefore “natural resource revenues represent a source of revenues like any other source, except that some provinces are luckier than others with respect to their endowments.”²⁹ The resource-endowed province receives rents for its nonrenewable assets, even if the resource is being depleted in the process. These resources are a free source of funding for public services, thereby directly raising the capacity of the province's public service delivery. Therefore, it seems bizarre to accept the proposition that such a windfall gain should not be taxed similarly to earned income.³⁰

4. The Incentive Argument

On a functional level, the Equalization of natural resource revenue may have a negative effect on provincial economic policy choices. As the Director of Research Services for AIMS asserts: “Equalization was not a program developed to promote economic growth, but it certainly does not exist to stunt or hinder prosperity.”³¹ Others argue that Equalization should affect a broader convergence of provincial fiscal capacities.³² However, critics of the program suggest that not only is Equalization not providing the necessary assistance to “have not” provinces, but it is actually stifling economic opportunities. This argument suggests that the formula has inadvertently built in particular incentives that can hinder economic development in recipient provinces. Because resource revenues are clawed back completely in the absence of a special agreement or the Generic Solution, provincial governments have little incentive to develop these industries. Furthermore, the formula fails to recognize the costs incurred by a government in the resource-development process. As a result, after infrastructure and incentive programs, the government may be financially worse off by pursuing economic development in the field of its nonrenewable natural resources.³³

4.1 Costs and Revenue Potential

One of the contributing factors to a structural disincentive is the manner that revenue is calculated. Currently, gross resource revenues typically enter the Equalization formula. However, calculations using gross revenue do not take into account a variety of costs involved in developing and exploiting natural resources. Therefore, it is more appropriate to use net revenues, i.e., the revenues that are left over after the government expenses to develop and collect the resource rents in question. This argument implies

that natural resource revenues are unique in nature. They require government investment in transportation infrastructure, environmental assessment and monitoring costs and policy costs. Once the resource industry is thriving the government incurs collection, assessment and auditing costs on the taxation side. Resource revenues may also involve administration costs.³⁴

For other revenue sources, some of the same costs exist. However, since these revenue bases are common to every province, the impact of ignoring these costs is limited. Natural resources are unique because it is only possible for certain provinces to generate resource rents. Therefore, only some provinces bear the additional expenditures associated with industry development. Furthermore, even among provinces that have access to natural resources, the developmental and extraction costs can vary. The leader of the Saskatchewan Party, Brad Wall, explains this phenomenon as it relates to Saskatchewan:

Significant infrastructure is required to extract it [oil] and to develop the industry. In ours here, we have a unique challenge, by the way. Well, it's not unique, but it's a challenge that certainly most of Alberta doesn't have in this regard, and it is that our oil is not quite as sweet and is not quite as light, so typically its not as easy to access. There are infrastructure requirements and there's a capital investment requirement that is very significant. I think that's why others, more than politicians, are now saying it is time for us to look at the whole question of whether non-renewable resources ought to be in the equalization formula.³⁵

According to this argument, it is inequitable to use gross revenue instead of net revenue.

The net measure would take into account the costs required to generate resources revenue.³⁶

Using gross revenues can result in significant overestimation of provincial income from a source. In real terms, the overestimation leads to striking Equalization penalties.

For example, John McDougall's book on Erik Kierans points out that the Quebec

Revenue Minister found that province's expenditures in support of the resource outweighed its income. However, in 1967 when resource revenues were brought into Equalization, Quebec's gross income resulted in a negative entitlement. Therefore, Equalization functioned to increase the net revenue loss from Quebec's resource sector.³⁷

4.2 Natural Resource Development Incentives

Excessive clawbacks punish provinces for the responsible development of their nonrenewable natural resources. As a result, recipient provinces have little incentive to reduce their reliance on Equalization in favor of developing their resource industries. Equalization builds in a moral hazard that reduces the incentive for rigorous developmental policies among "have not" provinces. Hubert Grubel describes how "have not" provinces react to the moral hazard:

Rational Adjustment occurs when adjustments are undertaken by the insured in response to changes in relative prices. For example, the owners of insured homes receive less return from measures to prevent break-ins. So they are less likely to install alarms, keep watchdogs or trim hedges.³⁸

The expended resources and effort required to breathe life into a new resource industry cannot be offset by the net profits after clawbacks from the Equalization Program. Instead of encouraging economic growth of resource-rich "have not" provinces, the formula actually creates incentives to slow or stall development. While provinces probably would not take steps to proactively stifle resource industries, they certainly will be less inclined to offer the financial resources required to encourage their growth

In the case of taxation incentives set up to encourage private-sector investment, the Equalization clawback can result in a net loss of provincial revenues. If a province derives revenue at a rate that is less than the national average, an increase in fiscal capacity results in a clawback that exceeds the new revenue. For "have not" provinces,

taxation rates that are lower than the national rate will create a net loss in overall revenue. Conversely, provinces that tax at a rate that exceeds the national average will enjoy an overall increase in net revenue. Therefore, the formula discourages preferential taxation rates that would encourage the development of a provincial resource sector.³⁹ Overall, the formula creates disincentives for provinces to incur the costs of infrastructure, taxation, and administration, which would encourage the development of a resource sector. Consequently, “have not” provinces are enticed to remain recipients of Equalization instead of taking the steps required to build their economies.

The main opponent of the incentive argument is Robin Boadway who states “there is no evidence that equalization tax-backs have deterred provinces from pursuing resource development.”⁴⁰ Boadway points to the oil industry in Saskatchewan and mining in Manitoba as examples of recipient provinces that have vigorously exploited their resources. Furthermore, once a nonrenewable resource is discovered in a province, all potential development will always be subject to a clawback. Therefore, it is only a matter of *when* the resource is exploited instead of *if* it will be exploited. Since the clawback will occur eventually, provincial governments have no incentive to postpone the development of the industry.⁴¹

Boadway’s argument has significant holes. First, contrary to his suggestion, there are several cases where evidence has pointed to the Equalization implications as the reasons why provincial governments have chosen to pass up opportunities to develop their natural resources. Notable cases occurred in Newfoundland’s treatment of Inco’s bid to develop a mineral deposit at Voisey’s Bay.⁴² Voisey’s Bay will be further discussed in the following section.

Secondly, Boadway makes the hasty assumption that the perpetual existence of clawbacks will cause provinces to rigorously pursue the development of natural resources. In order to foster the growth of some industries, the government may have to incur significant developmental costs. This is especially true when a large amount of infrastructure is required. In such a scenario, the loss in net revenues due to clawbacks discourages governments from providing healthy conditions for economic development. If, for whatever reason, the price of the commodity drops, or circumstances change, the province could have lost its chance to extract the greatest economic rent from the resource. Boadway does not give enough credence to the fact that provincial governments will be cost-adverse, while resource development is often expensive.

4.3 Real Effects

The case of Voisey's Bay in Newfoundland shows how the disincentive may impact provincial behavior.⁴³ In the late 1990s, Inco put in a bid to the government of Newfoundland to develop the nickel deposits in Voisey's Bay. Inco's proposal included investments of \$750-million immediately in a mine and mill, and a further \$95-million in underground exploration, plus a \$180-million experiment to see whether local chemical processing of the ore was feasible.⁴⁴ After protracted negotiations, Inco pulled out and invested instead in Argentina.⁴⁵

There are several possible reasons for Premier Brian Tobin's reluctance to close the deal. Tobin wanted Inco's nickel extraction to be accompanied by a smelting plant in Newfoundland. Many observers speculate that Premier Brian Tobin did not offer the incentives required to secure Inco's investment in Newfoundland because of the short term repercussions of the Equalization Program.⁴⁶ If Inco were to invest in a "have"

province, the province would reap all of the benefit from the development. However, because Newfoundland is a “have not” province, all of the revenue generated by an Inco development would be subject to a clawback in excess of 80 percent.⁴⁷ Therefore, a development that would create \$100-million of new wealth in a “have” province would create less than \$20-million in Newfoundland. The result is that Premier Tobin had every incentive to hold out for the smelting plant and the jobs.⁴⁸ As an article in the *Globe and Mail* pointed out during the negotiations:

Equalization’s spectre whispers constantly in Mr. Tobin’s ear, ‘Go for the jobs.’ It’s the only way to make Voisey’s Bay pay off for him, despite the fact that the project is now stalled and Canada already has excess processing capacity. Thus do equalization’s good intentions make fools of us all.⁴⁹

If the clawback ramifications influenced Premier Tobin’s negotiations, the Equalization Program is not functioning as it was originally intended. The disincentives of the clawback work against one of the core objectives of the Equalization Program: “promoting equal opportunities for the well-being of Canadians; [and] furthering economic development to reduce disparity in opportunities.”⁵⁰ If Equalization is actively quashing economic opportunities, significant changes must be considered.⁵¹

5. Conclusion

Natural resources appear to bring about unique challenges to the Equalization program. Bruce Winchester suggests that “(w)e treat natural resource revenues very unintelligently because we forget that they are fundamentally different from almost every other kind of government revenue. Not just a slice off the top: Actually nonrenewable.”⁵² The Economic Council of Canada also recognizes a distinctiveness that characterizes natural resources. In its 1982 report, the Council suggested that it is only appropriate to

subject a portion of natural resources to Equalization. The Conservative Party's 2004 and 2006 election platform contained promises to remove nonrenewable natural resources from Equalization completely.

If nothing else, the perception that natural resources are unlike other revenue has caused a chorus of objections and proposals. The Newfoundland and Nova Scotia agreements on offshore oil were a response to the clawback of natural resource revenue.

Chapter 3: *The Cases of Newfoundland and Nova Scotia*

Since the 1960s, Newfoundland and Nova Scotia have fought continuous battles with Ottawa over the revenue and control of offshore oil. The struggle involves much more than Equalization; it also encompasses jurisdictional and administrative issues. While the *Canada Oil and Gas Land Regulations* and the *British Columbia Offshore Reference Case* confirm federal jurisdiction over offshore oil, Newfoundland and Nova Scotia claim the right to shield offshore rents from the Equalization clawback.⁵³

In 1966, the first East Coast deep drilling program began 100 miles off the shores of Newfoundland. In 1967, the Sable Island drilling began, off the coast of Nova Scotia.⁵⁴ The emerging energy industry renewed the efforts of Newfoundland and Nova Scotia to secure jurisdictional authority and administrative control over offshore developments. The introduction of the National Energy Program in 1980 intensified the dissatisfaction in Newfoundland and Nova Scotia about the offshore energy regime.

The federal government reached a bilateral agreement in principle with Nova Scotia in March 1982. The proposal included shared administration and control over the oil fields. It also increased Nova Scotia's share of oil revenues. Not willing to compromise over jurisdictional issues, Newfoundland refused to join the negotiation process. In May 1982, Prime Minister Trudeau announced that Canada would take the Newfoundland offshore jurisdiction issue to the Supreme Court. Recognizing that the Supreme Court precedents favored the federal government in the past, Newfoundland reopened negotiations. In September 1982, Newfoundland agreed to an offshore arrangement that mirrored the one adopted by Nova Scotia.⁵⁵ The *Canada-Nova Scotia Agreement on Offshore Oil and Gas Resource Management and Revenue Sharing* and the

Canada-Newfoundland and Labrador Agreement on Offshore Oil and Gas Resource Management and Revenue Sharing were used as bases for formulating the official Accords. The final Newfoundland and Nova Scotia Accords were officially signed in 1985 and 1986 respectively. Together, the two agreements are referred to as the Atlantic Accords.⁵⁶

The Atlantic Accords are wide reaching agreements that deal with administrative structures, revenue sharing, Equalization clawbacks, and jurisdictional questions regarding offshore oil. Equalization was only one component of the Atlantic Accords. The Equalization provisions ensured that Newfoundland and Nova Scotia would initially receive all of the offshore revenues save the federal share of corporate income tax. The provinces would continue to receive this share of revenues until they reach a level of fiscal and economic prosperity that invokes the trigger. The trigger required the provincial fiscal capacity to be 123 percent of the national average. Moreover, for every percentage point that the provincial unemployment rate surpassed the national rate, the fixed trigger rate would increase by two points. The trigger created a significant shelter for the offshore rents of both provinces.⁵⁷

In order to ensure that Newfoundland and Nova Scotia remained the primary beneficiaries of the energy revenues as long as the trigger had not been activated, the Atlantic Accords provided offset payments. The federal government promised to provide payments to reimburse Newfoundland and Nova Scotia for future Equalization clawbacks relating to offshore rents. The offset payments topped off the provincial Equalization transfer to a level equivalent to 90 percent of the previous year's transfer. The offset mechanism was to last for ten years in Nova Scotia, and 12 years in Newfoundland.⁵⁸

In spite of the Atlantic Accords, by 2000 neither Newfoundland nor Nova Scotia had reached the level of economic prosperity that was forecasted in the 1980s. Upon the signing of the Atlantic Accords, then Minister of Energy, Mines and Resources of Canada, Jean Chrétien, predicted that “provincial revenues from Hibernia might be large enough to make Newfoundland a “have province” within five years of production.”⁵⁹ This kind of rapid economic growth was not achieved. As the offset provisions were winding down,⁶⁰ Newfoundland and Nova Scotia pursued a new deal. By 2004, revenue from the offshore industry totaled over \$1 billion for both provinces together. However, after the Equalization clawback Newfoundland retained only 12 percent and Nova Scotia kept 19 percent of the profits.⁶¹ The Atlantic Accords no longer provided effective shelter for offshore rents. Premier Williams and Premier Hamm joined together to renew the Atlantic Accords 1985 and 1986.

1. Positions

There are several reasons for the provinces to pursue a deal outside of the regular Equalization process. The negotiation process took nearly a year to complete. One of the main reasons for the drawn-out process was the rigid positions held by the Newfoundland and Nova Scotia governments, as well as the federal government. While the federal positions dealt with program feasibility, the Newfoundland and Nova Scotia position relied on the dilemma of nonrenewable natural resources and the clawback as explained in Chapter 2.

1.1 Newfoundland and Nova Scotia

Throughout the negotiation process Newfoundland and Nova Scotia insisted on keeping 100 percent of the revenues accrued through offshore oil. Their position was rooted in two propositions. The first is that the commitments and intentions of the 1985 and 1986 Atlantic Accords had not been fulfilled. The second argument dealt with the general problems of the Equalization clawback on natural resources as discussed in Chapter 2.

1.1.1 Atlantic Accord Unfulfilled

The Atlantic Accords were signed in 1985 and 1986, in the midst of unrealistic expectations regarding the amount and timing of offshore development. In spite of predictions that oil production would render Newfoundland and Nova Scotia “have” provinces within five years of production, in reality neither province generated huge revenues. The *Newfoundland and Labrador Royal Commission on Renewing and Strengthening Our Place in Canada* reported that by the time the offset payments expired in 2011, Newfoundland would have received a mere fraction of the originally intended benefits “unless both parties to the bilateral Atlantic Accord make the necessary adjustments to reflect the changes in the actual evolution of the offshore industry as compared to their earlier analyses and assumptions.”⁶² For Nova Scotia, the offset payment period was due to expire in 2004-05. Neither province's offshore industry realized the expectations of the mid 1980s. Moreover, the offset mechanism was triggered by smaller projects that did not generate anticipated revenue. Initial assessments of the offshore oil fields predicted that once production of oil commenced, the fields would be developed quickly. However, during the first years of production, the

fields were developed more slowly than anticipated. By the expiration of the offset provisions, neither province had generated the large offshore revenues that were predicted.⁶³ Therefore, by 2004, the 1985 and 1986 Atlantic Accords had not produced the intended effects.

The Atlantic Accords were created in the spirit of sharing all offshore revenue until each province attained “have” status.⁶⁴ Indeed, the 1982 Canada-Newfoundland and Canada-Nova Scotia agreements that were the precursors of the 1985 and 1986 Atlantic Accords contained numerous statements that suggest that Newfoundland and Nova Scotia were to be the long-term beneficiaries of their offshore industries.⁶⁵ For example, Section 15 of the 1982 Nova Scotia Agreement says, “the intention is that resource revenues from the offshore region shall be reduced only gradually to ensure that Nova Scotia’s fiscal and economic benefits are lasting.”⁶⁶ This statement implies that the offset mechanism should function to ensure that Nova Scotia retains its energy revenues during the most productive years of the oil field. The 1982 Newfoundland Agreement states that “it is recognized that Newfoundland should enjoy the major share of the revenue that offshore resources are expected to generate.”⁶⁷ Furthermore, both the 1985 and 1986 Atlantic Accords include a statement of “purposes.” One of the purposes is “to recognize the right of [the provinces] to be the principal beneficiary of the oil and gas resources off [their] shores, consistent with the requirement for a strong and united Canada.”⁶⁸

The Atlantic Accords failed to fulfill their most fundamental purposes. As explained earlier, the original intention was to guarantee that Newfoundland and Nova Scotia could reap the benefits of their offshore industries. In order for the provinces to

collect the offshore rents, the 1985 and 1986 Atlantic Accords needed to be amended. The provincial position demanded that Newfoundland and Nova Scotia remain the principal beneficiaries of offshore rents until such time as they meet or exceed a national average economic and fiscal capacity.⁶⁹

1.1.2 Allowing Economic Development

The second component of Newfoundland and Nova Scotia's position relies on the arguments against clawing back nonrenewable natural resources, as discussed in Chapter 2. Williams and Hamm use provincial ownership arguments and Boessenkool's nonrenewable resources-as-assets reasoning. However, the Newfoundland-Nova Scotia positions are *sui generis*. These provinces have been among the most impoverished regions of Canada since Confederation. The promise of an oil and petroleum industry offered the hope of long-overdue economic prosperity.

Williams and Hamm pointed out that when Alberta's oil industry was in its infancy, natural resources were not fully included in the formula. Therefore, that province could help its industry reach maturity before it had to deal with the clawback.⁷⁰ For Premier Williams, the offshore issue is about more than squeezing more money out of Ottawa: "It is about the province of Newfoundland and Labrador finally achieving our true potential.... We are asking only for our provincial share. We are asking only for a chance. A chance we deserve."⁷¹ Newfoundland and Nova Scotia wanted the one-time opportunity to convert offshore oil reserves into a thriving economy.

1.2 The Federal Government

From the beginning of the negotiation process in early 2004 to the signing of the deals, in February 2005 the federal position remained the same: Newfoundland and Nova

Scotia deserved special treatment due to their extreme indebtedness and economic disparity.⁷² In fact, the final deal included a substantial initial payment with the intended purpose (but not a legislated requirement) of paying down the provincial debts.⁷³ The only conflict between the federal position and the position of Newfoundland and Nova Scotia involved the extent of the special treatment. Martin sought conditions and ceilings that would contain the cost of the new Accords. The federal government wanted to put a cap on the clawback exemption. Specifically, the federal proposal set the ceiling at the fiscal capacity of Ontario.⁷⁴ The federal government also fought for a clause that conditioned the offset payments on balanced provincial budgets.⁷⁵ In the end, the federal government abandoned the Ontario ceiling⁷⁶ and the balanced budget clause.⁷⁷

2. Process

2.1 Closed Door Negotiations

Between 2001 and 2004, Nova Scotia and Newfoundland made several attempts to reopen the 1985 and 1986 Atlantic Accords. Nova Scotia's four year *Campaign for Fairness* included public awareness campaigns, press releases, articles, and a public signature campaign all designed to pressure the federal government into action.⁷⁸ Newfoundland's 2003 *Royal Commission on Renewing and Strengthening Our Place in Canada* highlighted the inadequacy of the original Accords and recommended a new deal for the provinces.⁷⁹ However, both provincial efforts failed to capture the attention of the federal government.

The first sign that the Liberal government in Ottawa was ready to reopen the offshore issue came on February 23, 2004 when the federal Minister of Natural

Resources, John Efford, confirmed that Paul Martin had asked him to look into the possibilities for reforming the Atlantic Accords. Efford announced that he would meet with fellow Newfoundlander Danny Williams to discuss all the options.⁸⁰ This would be the first of many meetings held between Williams and federal officials. Nova Scotia's Premier Hamm also participated in talks with the federal government. However, during the first phase Williams dominated the process.⁸¹

The first sign of concrete progress came on June 5, 2004 when Williams reported that he and Martin had reached a verbal offshore oil agreement during a telephone conversation.⁸² Hamm and Martin reached a similar verbal deal.⁸³ The exact terms of agreements were the subject of much contention in the future months. Hamm and Williams insisted that Martin promised to provide total reimbursements for all Equalization clawbacks on offshore oil—without qualification. Martin would later announce that the deals were always subject to certain limitations and ceilings. Williams wrote a letter confirming Newfoundland's understanding of the deal on June 10. No further contact was made between the provinces and the federal government until after the June 28 federal election.

By August, Williams grew anxious to move the deal forward. He wrote two letters to the Prime Minister confirming Newfoundland's support for the deal. Neither letter prompted a response from Ottawa. Williams maintained that the lack of response implied a confirmation that Martin had no objections to the agreement as specified in Williams' letters.⁸⁴

Between August and October, Newfoundland and Nova Scotia unsuccessfully attempted to push forward their version of the agreements. Both provincial governments

issued news releases and spoke publicly about their desire to finalize the agreements. The first formal response from Ottawa came in a letter from federal Finance Minister Ralph Goodale on October 24. In his letter, Goodale confirmed the existence of a deal, but added qualifications. The letter stated that the annual payments made to Newfoundland and Nova Scotia will be “subject to the provision that no such additional payment result in the fiscal capacity of the province(s) exceeding that of the province of Ontario in any given year.”⁸⁵ Goodale suggested—contrary to the Newfoundland-Nova Scotia position—that the Ontario clause had always been part of the discussions between Ottawa and the provinces.⁸⁶

Williams responded with hostility to Goodale’s letter. He accused the federal government of violating the June 5 agreement. After Williams placed a phone call to the Prime Minister that was not returned,⁸⁷ both Williams and Hamm rejected the terms set out in Goodale’s letter.⁸⁸ The rejection occasioned the beginning of the second phase of negotiation.

2.2 Public Pressure

The second phase of the negotiation process included antagonistic exchanges between the Newfoundland and Nova Scotia Premiers and the federal government. Person-to-person negotiations ceased and the battle for public sympathies began. The inflexible positions of the provinces and the federal government prevented productive mediation. In an interview with the CBC, a reporter asked if there was any flexibility in Newfoundland’s position. Williams responded unequivocally: “No, from my perspective, a deal is a deal. I mean if he [the Prime Minister] reached an agreement with me, he

clearly understood what it was, the wording was very simple – 100% of the revenues. It couldn't be any tighter or any simpler.”⁸⁹

On October 26, Williams boycotted the First Ministers' Meeting on Equalization. Hamm publicly supported Williams' position, but decided to attend the meeting himself.⁹⁰ Newfoundland's absence from the meeting incited harsh words from Scott Reid, the Prime Minister's Director of Communications. Reid rebuked Williams for not attending the meeting, suggesting that such cheap political ploys would hurt Newfoundland in the long run. While Reid later issued a public apology, it did little to quell Williams' anger.⁹¹ Williams announced that he would no longer participate in negotiations if Reid were involved. Martin refused to betray his communications officer, thus talks remained at a standstill.⁹²

In every speaking engagement, presentation, media conference, and news release, Williams and Hamm repeated their message: the Prime Minister had broken his end of the deal at the expense of the people of Newfoundland and Nova Scotia. The provinces' message was constant, and it was repeated over and over again. Eventually, evidence surfaced that the public campaign was resonating on Parliament Hill. On November 15, two federal Liberal MPs from Newfoundland, Scott Simms and Bill Matthews, broke ranks and voted for an Opposition motion on the Atlantic Accords.⁹³

2.3 Back to the Table

In early December, negotiations restarted. However, the provinces were not congenial participants. Williams and Hamm held out for their deal *sans* limitations or conditions. On December 7, Williams and his Minister of Finance flew to Ottawa to force an unscheduled meeting with Goodale.⁹⁴ This process was repeated several times

during December, each time involving more fanfare and public spectacle. Stories of Newfoundlanders weathering cold winter blizzards to cheer the Premier as he went off to Ottawa to fight for a deal filled the provincial media.⁹⁵ On December 23, Williams and Martin met in Winnipeg. Williams announced that he would not leave without a deal for Newfoundland.⁹⁶ When the meeting ended without agreement, Williams made a move that stirred controversy across the country.

2.4 The Flag Flap

Following the Winnipeg meeting, Williams announced that the negotiations were over. He explained that the federal government would not give Newfoundland and Nova Scotia a deal without conditions, therefore Newfoundland had indefinitely left the bargaining table.⁹⁷ Williams ordered the Canadian flag to be removed from most provincial government buildings. He announced that the flags would not be returned until Newfoundland got a deal.⁹⁸ The flag stunt achieved mixed results. Support for Newfoundland waned throughout the rest of the country. Premier Hamm disassociated his province from the move.⁹⁹ Williams decided to soften his position. He assured Canadians that the Canadian flags would eventually go up again with or without a deal ““because our problem is not with the people of the country. It’s with the Prime Minister, it’s with the leader of the country.”¹⁰⁰

In Newfoundland, whatever support Williams may have lost with the flag stunt was won back by Margaret Wenté’s January 6 column in the *Globe and Mail*. Wenté accused Newfoundland of mooching off the hard work of the rest of the country. She also personally attacked the Premier: “Mr. Williams reminds me of a deadbeat brother-in-law who’s hit you up for money a few times too often.... He’s been sleeping on the couch

for years, and how he's got the nerve to complain that it's too lumpy.”¹⁰¹ The article calls Newfoundland a welfare ghetto.¹⁰²

Williams was the first to respond to Wente's column. In a letter to the newspaper and a press release, the Premier stirred provincial nationalist sentiments. He defended Newfoundland's character and integrity. He suggested that the prevalence of these kinds of prejudices was precisely the reason why Newfoundland's government had lowered Canadian flags.¹⁰³ The Prime Minister also publicly expressed his disagreement with Wente's article.¹⁰⁴ Edward Greenspon, editor of the *Globe and Mail*, said that the reader response triggered by the column set records. On the first day alone, the newspaper received over 900 emails.¹⁰⁵ The people of Newfoundland banded together. Even a swimsuit maker discontinued the line of bathing suits that featured the Canadian flag.¹⁰⁶

2.5 Making a Deal

On January 10, Williams remounted the flags.¹⁰⁷ The last phase of negotiation involved a return to closed-door talks. Williams publicly requested a meeting with the Prime Minister in order to “clear the air.”¹⁰⁸ Williams ordered all his Cabinet Ministers to clear their schedules and stand by to discuss a potential deal.¹⁰⁹ On January 27, Williams, Hamm and Martin met in Ottawa. After 10 hours of deliberations, the three emerged with a signed agreement on offshore oil revenues.¹¹⁰ Williams professed that he was “very, very proud to be Canadian.”¹¹¹

The final deals give an estimated \$830 million in offset payments to Nova Scotia and \$2.6 billion to Newfoundland over an eight-year period. The offset payments are “equal to 100 percent of any reductions in Equalization payments [the clawback] from offshore resources revenues.”¹¹² If by 2012 the provinces remain Equalization recipients and

their per-capita debt servicing charges are not lower than four provinces, the offshore agreements will be extended to 2019-2020. If, at any time, Newfoundland or Nova Scotia no longer qualify for Equalization, the offset payments will be phased out so as to guarantee that each year's payment will be no less than two thirds of the previous year's payment.¹¹³

2.6 An Exceptional Process

The renewed Atlantic Accords received national attention, not only for their content, but also for the process by which they were negotiated. The Equalization formula is renewed every five years. Changes to the Program and the formula are a product of five years of formal and informal collaboration between the federal government and the provinces—though the federal government always makes the final decision. Equalization was renewed in 2004. However, the offshore deals were agreed to completely outside of this renewal process. Unlike the conventional practice, the deals were a result of bilateral and trilateral talks. At no point did the other provinces participate.

While the 1985 and 1986 Atlantic Accords did set a precedent for this kind of exceptional treatment, the 2005 round provoked much more national attention. A possible reason for the different public perception of the two processes may be the scope of the two agreements. The 1985 and 1986 Atlantic Accords were negotiated to solve issues of jurisdiction and administration. The Accords set down guidelines for a joint federal-provincial regulatory body and rent-sharing provisions. While the agreements did deal with Equalization, the rest of the country perceived them as a jurisdictional and administrative arrangement more than an Equalization “one-off.”

The 2004-2005 campaign dealt specifically with the Equalization component of the Atlantic Accords. This singular focus made the irregular process more apparent to the rest of the country. Furthermore, Williams' tactics were highly visible to all Canadians. The 2004 offshore deals mark a significant departure from the conventional process. Instead of competing with other governments' demands inside the five-year cycle, Newfoundland and Nova Scotia circumvented the process and secured bilateral deals with Ottawa.

3. Political Motivations

Outside factors weighed in the decision-making processes both on the provincial the federal sides. The political factors included two minority governments, a strong majority government, and an election.

3.1 Newfoundland

The election of Danny Williams' Conservatives in October 2003 was the turning point in the quest for a new Equalization deal. Williams led his party to an overwhelming majority, sweeping the legislature with 34 of the 48 seats and turfing out the Liberals who had governed Newfoundland since 1989.¹¹⁴

For Williams, there was little in the way of a downside to fighting a "no holds barred" campaign for a new Accord. Newfoundlanders had already rewarded his controversial antics in the 2004 election. Upon entering government, Williams' Conservatives immediately began the implementation of a tough debt-reduction strategy. Some of Williams' cost-cutting measures were unpopular with Newfoundlanders. With Williams' personal popularity falling to an all time low of 39% in Spring 2004,¹¹⁵ the offshore issue offered an attractive strategy to boost his personal popularity.

Williams successfully positioned himself as the champion of underdog Newfoundland.¹¹⁶ Because of his highly publicized actions such as his commitment to donating his Premier's salary to charity, Williams was able to portray a selfless Premier who had put his personal ambitions aside to "fight the good fight" for his province. As his campaign for a new deal gained publicity and momentum, Williams' popularity steadily climbed in polls. A Corporate Research Associates survey conducted between February 10 and March 4, 2005 found that 86 percent of Newfoundlanders were mostly or completely satisfied with Williams' performance.¹¹⁷

The only point during the process at which Williams' popularity was threatened was during the 17-day removal of the Canadian flag. However, whatever support the stunt cost the Premier was promptly regained following the Margaret Wente's January 6 *Globe and Mail* column. The column stirred nationalist sentiment in Newfoundland upon which Williams was able to capitalize.

While political factors were probably not the only motivation behind Williams' flamboyant campaign, the political reality cannot be discounted. Newfoundland's premier was not constrained by the limitations of a minority government. Therefore he was free to use his personality, leadership style, and majority, to fight a showy battle against the federal government. As a Halifax newspaper columnist pointed out: "No provincial premier has ever lost votes by beating up on Ottawa."¹¹⁸ With the new offshore agreement, Williams cemented a long-lasting legacy for himself in Newfoundland.

3.2 Nova Scotia

The political circumstances were very different in Nova Scotia. The two most important political factors were the minority government and the amount of oil involved. The 2001 provincial election returned a minority government to the provincial legislature. Premier Hamm's Progressive Conservatives were forced to find common ground with the provincial NDP and Liberals who came in second and third respectively.¹¹⁹ The offshore oil issue was a cause under which all parties could unite. In order to advance Nova Scotia's offshore position, John Hamm continued his *Campaign for Fairness* with a new partner: Danny Williams.

The minority government situation and Hamm's personal leadership style constrained the tactics available to the Premier. During the flag escapade, Hamm was careful to distance Nova Scotia from the controversy. He publicly sympathized with Williams' position, but continued alone in Nova Scotia's negotiations with Ottawa.¹²⁰ Throughout the campaign, Hamm was the more subdued of the two Premiers. While Williams routinely lambasted the federal government, Hamm kept his public discourse more cordial.¹²¹ Hamm never walked out of any important meetings, he did not fly to Ottawa demanding impromptu meetings, and he did not take down the maple leaf. In a minority government, such antics would have left Hamm susceptible to opposition criticism.

A second possible political factor that influenced Hamm's negotiation style was the smaller size of Nova Scotia's offshore reserves. As Williams pointed out, Nova Scotia had less to gain in the final deal because it has "fewer chips in the future pot."¹²² Because Nova Scotia did not have as much offshore oil, highly inflammatory actions

would have been more difficult to justify. As a result, the Nova Scotia negotiations proved considerably less tumultuous than the Newfoundland campaign. Hamm was able to conduct a civilized campaign, and join Williams at the signing table.

3.3 Federal Government

Paul Martin had significant political motivation to reach an agreement that was satisfactory for all three parties. The Sponsorship Scandal had provided Stephen Harper's Conservatives with plenty of ammunition against the Liberal government. For the first time in over a decade, the Liberal grip on Ottawa was insecure.

During the close 2004 federal election campaign, the seat configuration could not have been far from Martin's considerations. Newfoundland and Nova Scotia held five swing ridings that could have proved crucial in a close election. Newfoundland had three swing seats: Bonavista-Exploits, St. John's North, and St. John's South.¹²³ Nova Scotia also had three very tight races: Halifax, West Nova, and South Shore-St. Margaret's.¹²⁴ The June 5 telephone call in which Williams alleges Martin promised a renewed Accord *sans* conditions occurred right in the midst of the election campaign. The Halifax *Daily News* accuses Martin of welshing: "The strategy was simple: promise anything and deal with the fallout after victory and power were assured."¹²⁵ This statement probably exaggerates Martin's intentions; however, it is reasonable to assume that the timing of the promise and its election implications did affect Martin's considerations.

On June 28, a Liberal minority returned to Parliament. Martin faced the added pressures of an unstable minority government. The negotiation process promised to inflame similar Equalization grievances in Saskatchewan, New Brunswick, and the North West Territories.¹²⁶ Furthermore, the process threatened to renew Ontario and Quebec

objections to the alleged fiscal imbalance.¹²⁷ All of these issues would be difficult to confront in a minority government. These considerations may have led to the unwillingness of the federal government to pursue negotiations quickly.¹²⁸ They also may have inspired the federal government to insist on terms and conditions on the original June 5 oral agreement.

In the final stages of negotiations, the drawn-out battle was proving divisive to the country and the government. The federal Liberals were under considerable stress, as demonstrated by the two MPs breaking ranks on November 15, 2004 on the offshore issue. Williams' campaign demanded the attention of the entire country. By January 2005, the federal government was eager to see an end to the dispute. Indeed, in the final agreements, the federal government dropped the two main sources of contention: the Ontario ceiling and the balanced budget clause.

4. What about the rest?

The signing of the new Offshore Accords has implications for every province and territory. By sheltering offshore revenues from the clawback, the Accords of 1985, 1986, and 2005 have set a precedent from which the rest of the provinces may launch their own challenges. North West Territories Premier Joe Handly reasons that the economic challenges facing his people surpass those of Newfoundland and Nova Scotia. Therefore, Handly reasons that his Territory should keep the \$200 million clawed back each year resulting from the production of diamonds.¹²⁹ Premier Bernard Lord of New Brunswick also announced that he would be seeking offset payments for his province's natural

resource clawbacks.¹³⁰ Saskatchewan has joined the North West Territories and New Brunswick in seeking similar terms. Chapter 4 will examine the case of Saskatchewan.

Chapter 4: *The Saskatchewan Case*

The signing of the Offshore Accords in February 2005 added legitimacy to Saskatchewan's grievances with the Equalization Program. Saskatchewan's case is rooted in the 1982 Equalization renewal. The 1982 Equalization package was a product of a series of problematic conditions in the 1970s. International market prices for natural resources increased significantly. Resource-endowed provinces saw substantial growth in revenues, which increased fiscal disparities among provinces. In an effort to prevent Equalization costs from soaring, Ottawa amended the Equalization Program. The changes included a limitation on natural resource rents entering the formula. Only one-third of resource revenue was subject to Equalization. In addition, only one-third of the entire Equalization costs could come from natural resources.

After 1977, further amendments required 50 percent of natural resource revenue to enter the formula.¹³¹ As a consequence of the 1977 Equalization changes, Ontario became a "have-not" province. The prospect of Ontario receiving Equalization transfers was politically and financially unacceptable. The challenge facing policymakers was to find a way to legitimately exclude Ontario from receiving payments. The most substantial change in 1977 was the introduction of an income ceiling. The ceiling provided that no province would be eligible for Equalization if its per capita personal income was higher than the national average. This provision only affected Ontario. However, Ontario accepted the amendments based on a condition that the 1982 amendments would comprehensively address the problems in the Equalization Program.¹³² Leading up to the 1982 Program renewal, Equalization was on the brink of crisis. Governments recognized the need for a fundamental overhaul.

Several provinces devised proposals for a remodeled system of Equalization. Saskatchewan's proposal—coined NAS-20— was released in 1981. The proposal called for a 10-province national standard. However, only 20 percent of natural resources revenues would be included in the formula.¹³³ Had NAS-20 been implemented, it would have eliminated Saskatchewan's future issues with Equalization. The NAS-20 proposal minimized the weight of resource revenues—which are at the root of Saskatchewan's present Equalization issues. Because Saskatchewan is the only major oil and natural gas producer in the five province standard, these revenues are clawed back at confiscatory rates. Under the NAS-20 proposal the clawback on energy revenues would be reduced. However, the Saskatchewan proposal was not adopted.¹³⁴

The 1982 amendments fundamentally altered the formula. First, the ten province standard was replaced by the five province standard (FPS). The new formula excluded the oil revenues from Alberta, Newfoundland, and Nova Scotia, as these provinces were no longer part of the standard. Second, 100 percent of nonrenewable natural resources entered the formula. Together, these changes positioned Saskatchewan's natural resources for a disproportionate clawback. Saskatchewan is now the only province in the FPS that receives significant revenues from oil and natural gas. As a consequence, the province's oil rents are disproportionately penalized by the clawback. Furthermore, the full inclusion of nonrenewable natural resources guarantees that Saskatchewan's oil rents are subjected to clawback rates near to or exceeding 100 percent. This phenomenon will be further examined in the rest of the chapter.

In spite of the long-term negative implications for Saskatchewan, the province paid little public attention to these issues after 1982.¹³⁵ Few provinces were sympathetic to

Saskatchewan's position. Discussions about Saskatchewan's disadvantageous position in the Equalization Program remained largely out of the public sphere. Awareness remained confined to the official and sometimes ministerial levels.¹³⁶

1. Positions

1.1 Saskatchewan

Saskatchewan is actively calling for an immediate implementation of a Saskatchewan Energy accord modeled on the Newfoundland and Nova Scotia Offshore Accords. A second option the province has advocated is the complete removal of nonrenewable natural resources from the Equalization formula.¹³⁷ However, the Province does not want to see the discontinuation of the modern Equalization Program. Instead, Saskatchewan is calling for a comprehensive review of Equalization and an investigation into alternative ways of modeling the Program.¹³⁸ Saskatchewan has five primary concerns about Equalization.

1.1.1 Burden of the 5 –province standard

The 1982 adoption of the FPS introduced a host of problems for Saskatchewan. In a ten province standard, every province's revenues are treated equally. However, when certain provinces were excluded from the standard, a discrepancy in the treatment between standard and non-standard provinces emerged. In all provinces, an increase in revenues will lead to a loss in Equalization entitlements (clawback). The clawback results from a calculation in which revenues are multiplied by the national average tax rate for the revenue—regardless of the province's own tax rate. An increase in revenues in a province in the FPS will also raise the FPS. The FPS penalizes Saskatchewan for

being the only significant oil and gas-producing province in the standard. Because Newfoundland, Nova Scotia and, most importantly, Alberta are excluded in the FPS, Saskatchewan oil revenues almost exclusively determine the standard by which oil and gas revenues are equalized. Therefore, by definition, Saskatchewan's revenues accruing from New Oil, Old Oil, Heavy Oil, Third Tier Oil, Heavy Third Tier Oil, Natural Gas, Sale of Crown Leases, and Other Oil and Gas, will be clawed back at a nearly confiscatory (100 percent) rate. Saskatchewan experiences extremely high annual clawbacks because the FPS overstates "the importance of resources to the fiscal capacity of Saskatchewan, which is a direct result of the absence of Alberta's wealth from the five-province standard." ¹³⁹

The direct impact of the FPS and the consequent exclusion of Alberta's energy revenues is the penalization of all new oil and gas developments in that province. Saskatchewan argues that this unique situation prevents the province from enjoying a reasonable proportion of the government revenue arising out of its oil and gas industry. Premier Calvert notes: "The formula seems almost designed to make provinces like Saskatchewan poorer in the federation, and that seems to me to be quite absurd." ¹⁴⁰

1.1.2 Without a Generic Solution

The application of the Generic Solution also disadvantages Saskatchewan. As explained in Chapter 2, the Generic Solution protects provinces that have more than a 70 percent share of a national revenue source. However, instead of using the five provinces of the FPS group to calculate eligibility for the Generic Solution, all provinces are included. This discrepancy causes negative consequences for Saskatchewan. Saskatchewan's has significantly more than 70 percent of the oil and natural gas revenues in the FPS. However, Saskatchewan does not have more than 70 percent of the national

ten-province energy revenue bases. Therefore, this province's energy revenues do not qualify for the Generic Solution. If the Generic Solution were instead calculated using the FPS to accurately reflect the true implications of the clawback, three of Saskatchewan's oil revenue bases would qualify for protection (73.8 percent of new oil, 94.2 percent of heavy oil, 97.4 percent of third-tier oil).¹⁴¹ Because of the FPS and Saskatchewan's disqualification from the Generic Solution, the province's nonrenewable resources, and energy revenues in particular, are subjected to excessively high clawback rates.¹⁴²

1.1.3 The “Confiscatory” Clawback

“Confiscatory” Clawback is a term coined by Professor Thomas J. Courchene. It refers to case where the Equalization clawback confiscates a particular revenue source at a rate of 100 percent or more. Courchene highlights particular instances in which some Saskatchewan revenue bases have been clawed back by more than 100 percent. This phenomenon can be attributed to several factors. The first involves the method of measurement. Most natural resource revenues that enter the Equalization formula are not the actual amounts earned by a province. Instead, the calculation is determined externally through aggregates and averaging. Essentially, the Equalization calculation estimates what the province *could* have earned if it had set its tax rates at the appropriate level instead of what it *actually* earned. This approach is necessary to eliminate perverse incentives to use royalty levels and taxation rates to maximize a province's Equalization transfer. A confiscatory situation can occur when the formula assumes that a province can efficiently tax at a level that is in fact inflated. Courchene uses the example of Crown Lease Sales in Saskatchewan to demonstrate the phenomenon.

According to the Equalization calculation, for the fiscal year 2000-2001, Saskatchewan could tax the sale of Crown Leases at a rate of 15.6 percent. However, Saskatchewan's actual taxation rate was only 6.9 percent. Therefore, the Equalization formula assumes that the Saskatchewan government is under-collecting revenues from this source by 8.9 percent. There are several reasons why Saskatchewan's taxation rate would be lower than the rate determined through the Equalization formula. First, Saskatchewan could be deliberately setting its rate low in order to attract private investment to its oil and natural gas industry. If this is the case, then it is reasonable for the province to endure the confiscatory clawback. However, the low taxation rate may also be attributed to the true value of Saskatchewan's leases. In the Equalization formula, there is only one category for sale of crown leases. Therefore, the formula implicitly assumes that all leases in every province will be worth an equal amount. In reality, this is not the case. Some leases are more valuable than others because the oil is easier to extract. For example, an investor will be willing to pay more for a lease in Alberta that has the potential to reap greater returns than for a lease in Saskatchewan which may deliver less revenue. Consequently, using external aggregates to determine the potential tax rate for sale of crown leases is not always an accurate or impartial method of calculating Equalization entitlements. Due to these factors, in the fiscal year 2000-2001 Saskatchewan's revenue from sales of Crown leases was clawed back by 201.6 percent.¹⁴³

1.1.4 Disincentive for Development: Saskatchewan's Voisey's Bay

Apache Canada Ltd. is one of Saskatchewan's largest oil and gas producers. In 2003, Apache brought a project proposal to the provincial government. Apache wanted

to inject carbon dioxide into an oil field near Midale, thereby extending the life of the oil field by 20 to 25 years. The company requested from the Province several fiscal incentives to make the project more financially manageable. By the government's own estimates, Saskatchewan would receive approximately \$105 million from the project. However, the project would result in a clawback of approximately \$166 million.¹⁴⁴ The discrepancy between the actual earned revenue and the Equalization clawback is partly due to the costs that the Saskatchewan government would incur in order to encourage and facilitate the project. These costs include infrastructure investments, tax rebates, and other incentives. This projected clawback rate was 150 percent over the life span of the project. Premier Calvert describes his province's dilemma: "Due to the high cost of this type of project, Saskatchewan was faced with a choice: provide the fiscal incentive, or not have the project succeed."¹⁴⁵ The Province proceeded with the Apache proposal, including the fiscal incentives, in spite of the Equalization repercussions. However, the clawback disincentives were a significant consideration.

Saskatchewan estimates that 30 billion barrels of heavy oil in the ground are not presently being recovered because of the high cost of the necessary technology. The clawback limits the province's capacity to support the development of such technology. This undeveloped oil effectively abandons a trillion dollars in the ground.¹⁴⁶ The Premier emphasizes that

these clawback rates are so excessive that they have become a serious consideration in our review of such projects. At present, the equalization program is a disincentive for the development... of projects in Saskatchewan that create jobs, enhance our national energy self-sufficiency. (sic)¹⁴⁷

The disincentives in the Equalization formula create a dilemma for the Saskatchewan Government. It must choose to invest in development projects and technology that may

lead to a short-term decline in overall provincial revenues, or decline to invest and absorb the long-term economic consequences. Revenues from oil and natural gas make up over \$1 billion of the provincial budget. In the 2006-2007 estimates, these revenues constituted over 15 percent of provincial income.¹⁴⁸ The large proportion of oil and natural gas in the Saskatchewan budget creates significant Equalization disincentives in terms of government investment.

1.1.5 The Offshore Deals—the case for equity

The Newfoundland and Nova Scotia Offshore Accords fundamentally altered Saskatchewan's position within the Equalization Program relative to the other provinces. With the federal government's decision to allow Newfoundland and Nova Scotia to shelter their offshore oil rents, Saskatchewan became the only province subjected to a confiscatory oil and natural gas clawback. Alberta, Saskatchewan, Newfoundland and Nova Scotia are the primary oil and gas producers in the country. The latter two have successfully sheltered these rents through the Offshore Accords. Alberta's fiscal capacity firmly entrenches the province in "have status" thereby rendering the clawback irrelevant. However, Saskatchewan is closer to the "have not" line. The elimination or reduction of the energy clawback would result in the resumption of Equalization transfers to that province. Therefore, Saskatchewan is now the only province that suffers a high clawback for its oil and gas revenues.

The Saskatchewan government is lobbying the federal government for a new energy Equalization arrangement on equity grounds. Premier Calvert explains: "What we see of course is equity and fair treatment of the resource base of all provinces. That principle, now established in Atlantic Canada, I think clearly now should apply... across the nation."¹⁴⁹ Calvert notes that the high cost of offshore oil and gas extraction is one of

the reasons that the Atlantic Accords were enacted. If this is the case, then it is reasonable to argue that CO₂ injection in Saskatchewan's oil fields qualify for a similar accord due to the high costs of extracting the oil reservoirs.¹⁵⁰ A similar case can be made for the high costs of extracting Saskatchewan's heavy oil.

Since the implementation of the 1985 and 1986 Atlantic Accords, which effectively allowed Newfoundland and Nova Scotia to protect 70 percent of their oil revenues from the clawback, Saskatchewan's position highlighted the discrepancy in the Equalization Program. Saskatchewan reasoned that the same protection should be extended to its energy revenues in accordance with principles of fairness and equity.¹⁵¹ However, instead of remedying the inequitable treatment, the federal government extended even greater protection to offshore oil. Under the February 2005 Offshore Accords, Newfoundland and Nova Scotia retain 100 percent of the revenues from their energy sector. However, at best, Saskatchewan can only keep 10 percent of its oil and gas revenues.¹⁵² In fact, as demonstrated by Thomas Courchene, in some years Saskatchewan loses all of its energy revenues to the Equalization clawback. Saskatchewan is seeking an Energy Accord or Equalization reform that will allow energy revenues to remain in the province.¹⁵³

1.2 Ottawa

1.2.1 Prime Minister Martin

Once the Newfoundland and Nova Scotia Offshore Accords were signed in February 2005, Ottawa intended to put the Equalization issue aside until the scheduled formula renewal in 2008. However, the ink was not yet dry when Saskatchewan and other provinces demanded their own special Equalization provisions. It stands to reason that if

Martin granted Saskatchewan an Energy Accord, then the entire Equalization Program would be up for negotiation. Instead of opening the door to multiple side-deals, the federal government appointed a five-member expert panel to examine the Equalization Program and Territorial Financing scheme and make recommendations. The O'Brien panel allowed the federal government to demonstrate that the Equalization issue remained top priority without actually making immediate changes. Finance Minister Goodale noted that at any given time the Equalization Program consists of over 1,320 moving parts.¹⁵⁴ Before any additional changes or "one-offs" were made, the federal government argued that it needed the advice of the Expert Panel on Equalization and Territorial Formula Financing.

Martin and Goodale emphasized that Saskatchewan does not share the same circumstances as Newfoundland and Nova Scotia. They argue that fairness does not necessarily mean uniformity. Goodale states that

In a country as big and diverse and complicated as Canada, fairness is not a simple matter of one-size fits all. The various provinces and territories unfortunately do not share the same geography, the same history, the same population bases, the same physical resources, both renewable and nonrenewable, or the same level of economic development or future potential. A cookie cutter approach from province to province or from region to region has never worked in Canada and likely never will.¹⁵⁵

Newfoundland and Nova Scotia are unique in respect to their debt loads. While Newfoundland and Nova Scotia's debt to GDP ratio are 63 percent and 43 percent respectively, Saskatchewan is in line with the average for all provinces at around 25 percent.¹⁵⁶ By 2005, Saskatchewan had achieved "have" province status. The provincial government delivered a "good news" budget and forecasted more surpluses in the future.

This was not the portrait of a province in dire fiscal need. Therefore, Martin was not willing to negotiate an immediate Energy Accord.

1.2.2 Prime Minister Harper

Prime Minister Harper came to power with a different perspective than that of his Liberal predecessors. The Conservative Party's election platforms in 2004 and in 2006 promised to remove nonrenewable natural resources from the Equalization formula.¹⁵⁷ Harper continues to promise that his government will honour its election commitments. Equalization reform and the correction of the fiscal imbalance are part of Harper's vision of the new "Open Federalism."¹⁵⁸ If the federal government indeed does fulfill its commitments, Saskatchewan's future grievances will be eliminated without the negotiation of a separate Energy Accord.

However, during the first session of the new Parliament, the Harper government did not move forward on its Equalization commitments. In fact, the Conservatives seem to be back stepping on their previous commitments. In June 2006, Federal Finance Minister Jim Flaherty stated that "The government of Canada has not taken a position on (how to fix equalization) and that continues to be our position now – that we haven't taken one."¹⁵⁹ Moreover, Flaherty warns Saskatchewan that a bilateral energy accord is not in the cards: "Agreeing as we all did on principle-based approach to equalization is very important because of the ... lack of principle-based approach to equalization previous."¹⁶⁰ The Finance Minister was referring to the Offshore Accords.

2. Process

2.1 Inconspicuous Negotiations

In November 2005, the Saskatchewan Government released a report that detailed all of its efforts to date to secure a new Equalization arrangement. The news release asserts that throughout the 1990s, the provincial government made continuous efforts to have rolled back the 1982 Equalization amendments— specifically, the removal of Alberta from the standard.¹⁶¹ However, while Saskatchewan maintained a consistent position (a return to a ten-province standard with less than 100 percent inclusion of natural resources) it found few allies among other provinces. Newfoundland and Nova Scotia were negotiating separately from Saskatchewan for greater control and retention of offshore oil revenue. Alberta's strong economy and revenue-earning capacity entrenched the province firmly in "have" status.¹⁶² While Alberta supported Saskatchewan's position in principle, it had little interest in participating in a political battle with Ottawa.¹⁶³ Saskatchewan's Equalization grievances received little public attention; therefore, the province chose to focus its attention on more popular aspects of Equalization reform.¹⁶⁴

As Saskatchewan's energy revenues grew, the province's Equalization troubles increased. Due to the inaccurate calculation of several energy-related revenue bases, Saskatchewan's fiscal capacity was being grossly overestimated. Moreover, the problem of being the only member of the FPS with growing oil and gas revenues guaranteed nearly confiscatory clawbacks. As a consequence, Saskatchewan's energy revenues were being clawed back in excess of 100 percent. However, with little support, Saskatchewan's Equalization grievances remained confined to discussions and analyses

by public servants. The issue never became the subject of inter-provincial negotiations or public campaigns.¹⁶⁵

2.2 The Revelation

Phase two of Saskatchewan's negotiations was initiated from outside government. Early in 2004, Thomas J. Courchene consulted with the Saskatchewan Government about a paper he was writing. The piece: *Confiscatory Equalization: The Intriguing Case of Saskatchewan's Vanishing Energy Revenues*, presented calculations that clearly demonstrated a clawback in excess of 100 percent of the province's energy revenues. Courchene's article acted as a catalyst for Saskatchewan's negotiations. The piece was published by the Institute for Research on Public Policy. Courchene also had an article published in the *Globe and Mail*.¹⁶⁶ The detail in the paper gave Saskatchewan the substance it needed to instigate meaningful dialogue with Ottawa. Courchene consulted with the Saskatchewan Government in early 2004 and his work was published in March 2004. During phase two of negotiations, Premier Calvert and Finance Minister Harry Van Mulligen met directly with their federal counterparts to secure compensation for the excessive clawbacks.

In February 2004, for the first time, the Saskatchewan government explained the confiscatory clawback to the public. In a February news release, the Government noted that "[a]chieving higher resource royalties can result in a loss in Equalization payment of over 100 percent.... Our province will have to continue to push the federal government for meaningful reform to the Equalization program."¹⁶⁷ The province's public objections to the excessive clawback on its energy revenues yielded a prompt response from the federal government. On March 19, 2004, federal Finance Minister Ralph Goodale,

offered Saskatchewan a one-time payment of \$120 million to offset the clawbacks that exceeded 100 percent of the revenues in the Crown Lease category.¹⁶⁸

Saskatchewan responded by increasing its demands on the federal government. The province petitioned Ottawa for compensation for its mining revenue categories which were “being incorrectly penalized \$40 to \$50 million each year under the current mining tax base,”¹⁶⁹ (the mining clawback was also highlighted in Courchene’s paper). Saskatchewan emphasized that a long-term solution needed to be negotiated. In particular, Van Mulligen stated “[w]e want the same deal as the Maritime Provinces.”¹⁷⁰ Van Mulligen was referring to the 1985 and 1986 Atlantic Accords which provided offset payments for energy revenue clawbacks. Newfoundland and Nova Scotia also benefited from the Generic Solution.¹⁷¹

On March 24, 2004, only a week after Ottawa announced the \$120 compensation payment, Van Mulligen unveiled a \$75,000 Equalization ad campaign designed to inform and mobilize Saskatchewan residents. The ad ran in provincial newspapers for two weeks, highlighting the unfair treatment of Saskatchewan energy and mining revenues. The ads did little to unite partisan factions in Saskatchewan. Saskatchewan Party Leader, Brad Wall, criticized the government for spending taxpayers' money on the campaign so soon after the dialogue had been opened with Ottawa. While the Saskatchewan Party expressed supports for the province’s position on Equalization, Wall suggested that the Government’s efforts were misplaced. Calvert should try lobbying the Prime Minister and the Finance Minister, “not provincial residents.”¹⁷²

The ads also failed to rally Saskatchewanians behind the Equalization cause. In fact, columnist Murray Mandryk suggests that “this NDP campaign seems more suspicious

than sincere.” The media pointed out that the Equalization issues predated Courchene’s paper. Furthermore, if Saskatchewan has legitimate cause to seek a deal similar to the 1985 and 1986 Atlantic Accords, then “why hasn’t it [the Saskatchewan Government] negotiated a deal in the past 12 years?”¹⁷³ The Calvert Government faced media speculation that the ad campaign was merely an attempt to distract Saskatchewanians from the “bad news” budget that was due to be announced that week.¹⁷⁴

The federal response to Saskatchewan’s Equalization campaign was negative. Goodale called the ads “juvenile.”¹⁷⁵ He also pointed out that Ottawa’s response had been prompt and generous:

When do they [the Saskatchewan Government] remember a federal finance minister who delivered a cheque for \$120 million cash on the dash to the government of Saskatchewan, within three or four weeks of that government raising a problem? When have they before seen performance like that?¹⁷⁶

Martin made no public response to the Saskatchewan ads.

2.3 Stalemate

On April 16, 2004 Premier Calvert traveled to Ottawa, hoping to promote Saskatchewan’s case to Martin. Calvert’s Equalization agenda was endorsed by a unanimous resolution passed by the Saskatchewan legislature.¹⁷⁷ Unfortunately, the Premier did not have the full attention of the Prime Minister. Calvert’s visit was part of the federal government’s announcement of a new health care package. According to the Prime Minister’s Office, Martin wanted to discuss BSE and Aboriginal issues.¹⁷⁸ As a consequence, Saskatchewan’s Equalization problems were not a top priority for Martin or for the general public.¹⁷⁹ After the meeting, Calvert reported that no new Equalization agreement had been reached between Saskatchewan and Ottawa, “but I was encouraged by the time we were able to spend together.”¹⁸⁰ According to the Premier, Martin promised

to have the federal Finance Minister look into the claim that Saskatchewan continued to suffer energy clawback rates in excess of 100 percent.¹⁸¹

In the aftermath of Calvert's meeting with the Prime Minister, Ottawa made no indication that a deal was in the cards for Saskatchewan. Goodale emphasized that the federal government was not eager to reopen the Equalization Program which been renewed only a few months earlier. As for extra-formula arrangements, Goodale noted that he was not willing to fix Saskatchewan's problems "in a sort of one-off situation on the back of an envelope."¹⁸² Neither Martin nor Goodale appeared ready to seriously consider Saskatchewan's Equalization concerns. The April 16th meeting was the last one-on-one encounter with the Prime Minister or the Finance Minister until after the federal election in June.

On April 28, 2004, Saskatchewan's Finance Minister Harry Van Mulligen presented the province's Equalization case to the Standing Senate Committee on National Finance.¹⁸³ Calvert noted that Senate testimony is not as effective as direct negotiation, but that any effort to rouse public debate would benefit Saskatchewan's cause.¹⁸⁴

On May 28, Van Mulligen wrote a letter to Goodale, reiterating Saskatchewan's position and requesting an Energy Accord. On June 8, Van Mulligen wrote another letter to Louis Levesque, the federal Assistant Deputy Minister of Finance. In the same month, Calvert sent a letter to all three federal parties requesting that the leaders publicly state their positions regarding the Equalization Program in light of the ongoing election campaign.¹⁸⁵ While the Conservatives and the NDP promised drastic change including returning to a 10-province standard (Conservatives and NDP) and completely eliminating

nonrenewable natural resources from the formula (Conservatives), the Liberals made no concrete proposals.¹⁸⁶

2.4 The Final Concession

In September 2004, after the election, Goodale promised Saskatchewan an additional \$340 million for the excessive energy clawback.¹⁸⁷ The federal action seemed to indicate good faith heading into the October 26 First Ministers' Meeting in Regina. Calvert emerged from the First Ministers' Meeting with \$367 million - \$27 million more than the province originally expected.¹⁸⁸ The meeting also resulted in a \$10 billion dollar infusion of federal cash into the existing Equalization Program. Danny Williams' dramatic exit overshadowed any impact Calvert's case may have made at the meeting.¹⁸⁹ The meeting marked the last window of opportunity for Saskatchewan to make its case until after the Offshore Accords were signed in February 2005. While Saskatchewan viewed the \$367 million payment as a small step towards a larger Equalization arrangement, the federal government viewed it as the unofficial closing of negotiations. Between October 2004 and January 2005, the Saskatchewan government had little communication with Ottawa regarding Equalization.

2.5 The Offshore Accords

The signing of the Newfoundland and Nova Scotia Offshore Accords in February 2005 bolstered Saskatchewan's position. Two days after the agreements were penned, Saskatchewan served notice that it would be formally pursuing its own bilateral arrangement.¹⁹⁰ Previously, Calvert had been seeking an arrangement similar to the Atlantic Accords of the 1980s, i.e., offset payments to protect a *portion* of the clawback on energy revenues. However, once the new Accords were finalized, Calvert expanded

Saskatchewan's demands to reflect the provisions in the February Offshore Accords, i.e., protection for *100 percent* of energy revenues.¹⁹¹

During this phase of negotiations Calvert gained an unexpected ally in the Conservative Party of Canada. Several Saskatchewan MPs, including Brian Fitzpatrick, Lynn Yelich, and Tom Likuiski, became very vocal proponents of the Saskatchewan position.¹⁹² The Conservative support culminated in a vote in the House of Commons on legislation that would have allowed Saskatchewan to retain all profits from the energy sector. The bill was defeated by the Bloc Quebecois and the Liberals.¹⁹³

In spite of a February 2005 meeting between Calvert and Martin, Saskatchewan appeared to be no closer to an Equalization Accord. The Premier built a unified coalition of partisan support for the Equalization battle, including Saskatchewan Party leader Brad Wall and Liberal Party leader David Karwaki.¹⁹⁴ He also met with the editorial boards of the *Globe and Mail* and *Maclean's* magazine. In addition, Calvert presented Saskatchewan's case at a luncheon speech at the Empire Club of Canada in Toronto.¹⁹⁵

Between March and May 2005, the Premier had several opportunities to meet with Martin. However in spite of two meetings designed specifically to discuss Equalization, the Prime Minister would not offer any special deal.¹⁹⁶ Van Mulligen and the Saskatchewan Party Finance Critic, Ken Cheveldayoff, traveled to Ottawa to testify before the Senate Committee on National Finance. Later in March, Calvert presented Saskatchewan's case to the Parliamentary Committee on Fiscal Imbalance. The Premier remained optimistic that the Liberals wished to close the Equalization file before an election.¹⁹⁷ However, Goodale remained reluctant to negotiate a "one off" with

Saskatchewan. In fact, Goodale told reporters that all future Equalization matters would probably not be decided until after the Expert Panel on Equalization delivered its report.¹⁹⁸

The summer of 2005 marked Saskatchewan's centennial. The provincial government hoped that the centennial fanfare and resulting national attention would induce the federal government to reopen Equalization negotiations. Deputy Premier Clay Serby publicly urged the Prime Minister to use the centennial celebration as an opportunity to announce a Saskatchewan Energy Accord.¹⁹⁹ However, the federal government expressed little interest in moving forward with a Saskatchewan Equalization arrangement.

2.6 Open Hostilities

By October, Calvert was clearly disappointed with the lack of progress his Equalization bid had made. Calvert accused the federal government of negotiating in bad faith: "A month and a half ago we were standing together in Saskatoon both indicating progress was being made. Since then I have seen no progress."²⁰⁰ In the fifth phase of negotiations, Calvert gave up on direct negotiations with the federal government. Instead, the Saskatchewan government focussed all of its attention on the media and the public.

Attempting to reproduce Newfoundland's successful negotiations, Calvert borrowed a tactic from Danny Williams. On November 10, 2005, the Saskatchewan government kicked off a new advertising campaign aimed at "getting the public on-side."²⁰¹ Calvert held an emergency news conference to criticize the Liberals for ignoring Saskatchewan's cause. An observer at the new conference noted Calvert's hostile disposition: "Pastor Lorne fumed in what (for him) was a decidedly un-

Calvertesque display of temper.”²⁰² The Premier announced that his government would be running newspaper ads, an internet site, an on-line petition, and distributing thousands of little red flags. Ultimately, the goal of the \$300 000 campaign was to use public pressure to force Martin into negotiations.²⁰³ Symbolically, “Raise a Flag” was meant to separate Saskatchewan’s actions from the highly controversial Williams strategy of lowering Canadian flags. By raising a flag, Calvert hoped to draw attention to Saskatchewan’s position without offending national sensibilities. Calvert described his intentions: “We are not wanting in any way to divorce ourselves from the nation or the future of this great nation, but... we want to be a strong, strong player within Canada.”²⁰⁴

The federal government did not respond favourably to the Saskatchewan campaign. Goodale took particular offense at the ads: “They’ve [the Saskatchewan Government] obviously decided that this is going to be a politically nasty campaign and that it is going to be directed squarely at me as an individual.”²⁰⁵ On November 18, Goodale wrote a letter to the *National Post*. He emphasized that the Ottawa had already provided Saskatchewan with compensation payments on two occasions. Any further action would wait for the report of the Expert Panel on Equalization. Moreover, Saskatchewan’s attention would be better focussed on building its economy.²⁰⁶ The federal Finance Minister’s strong reaction did not concern Saskatchewan. In fact, Van Mulligen was “pleased that the campaign is getting under Goodale’s skin.”²⁰⁷ “Raise a Flag” was discontinued when the Martin government fell on November 28, 2005.

In retrospect, Van Mulligen concedes the Raise a Flag campaign did not achieve its desired results. Saskatchewan’s Equalization issues are complex. The Raise a Flag episode clouded the issue for the general public. However, Van Mulligen notes that the

campaign was successful at enticing the Saskatchewan federal Conservative MPs to publicly offer their full support for the Province's position. The MPs are now on record as declaring support for excluding 100 percent of nonrenewable natural resources from Equalization. These clear statements may provide future ammunition for Saskatchewan's negotiations.²⁰⁸

2.7 The Election and the Aftermath

On January 23, 2006, Steven Harper's Conservative Party won the federal election and formed a minority government. The Conservatives assured Saskatchewan that they intended to exempt nonrenewable resources from the Equalization formula. However, Harper cautions that due to the challenges of governing in a minority, it may not happen right away.²⁰⁹ On March 23, Calvert traveled to Ottawa to meet with Prime Minister Harper about Equalization, among other topics.²¹⁰ The Premier found the Prime Minister sympathetic to Saskatchewan's position; however, Harper offered no time line as to when Equalization reforms would ensue.

At present, Saskatchewan's Equalization case remains unresolved. Several recent developments may influence the eventual outcome. On April 6, Finance Minister Andrew Thompson released Saskatchewan's provincial budget. The NDP offered major tax cuts and program spending while still maintaining a budget surplus. University of Regina professor Ken Rasmussen speculates that the "good news" budget will make it more difficult for Saskatchewan to make its Equalization case: "I think the federal government would laugh in their face, saying 'listen you don't have any budget problems.... Talk of correcting the fiscal imbalance doesn't have the same urgency for

the Conservative Government.”²¹¹ The province’s healthy financial situation will not inspire Harper to rush forward with a Saskatchewan Energy Accord.

Another recent development is the release of the Council of the Federation’s report on the fiscal imbalance. The report, *Reconciling the Irreconcilable, Addressing Canada’s Fiscal Imbalance*, recommends that the Equalization Program return to a 10-province standard and continue to include 100 percent of natural resources.²¹² Calvert expressed disappointment that the report did not deal with Saskatchewan’s claim for an Energy Accord. However, Calvert is not concerned about the position taken by the Council of the Federation. As the Premier points out: “This [Equalization] is a federal program. What the premiers have to say about is of interest but this is a federal program.”²¹³

In May 2006, the Expert Panel on Equalization and Territorial Formula Financing, chaired by Al O’Brien, released its recommendations in a report entitled, *Achieving a National Purpose, Putting Equalization Back on Track*. O’Brien’s recommendations included a 50 percent inclusion rate of nonrenewable natural resources; a return to formula-driven Equalization (the abandonment of the extra-formula approach that gave rise to the Offshore Accords); a ten-province standard; the simplification of the formula through consolidating revenue sources; and the re-emphasis of the principles behind Equalization.²¹⁴ Saskatchewan officially opposes the Panel’s recommendations, preferring instead the full exclusion of nonrenewable natural resources. In the end, the success of Saskatchewan Equalization bid will depend on the willingness of the federal government to negotiate.

3. Political Motivations

3.1 The Federal Government

Negotiating a Saskatchewan Energy Accord was not a politically attractive prospect for the federal government. Ottawa's reluctance can be explained by three political factors. First, the electoral considerations did not work out in Saskatchewan's favour. The Offshore Accords were initiated by a telephone call between Prime Minister Martin and Premier Williams in the middle of the 2004 election campaign. As discussed in the previous chapter, Newfoundland and Nova Scotia held crucial seats. By contrast, the federal Liberals had little chance of increasing their seat count in Saskatchewan—which promised to return a Conservative landslide. Therefore, the province's Equalization bid did not carry the promise of electoral returns for the Liberal government.

The second political consideration working against Saskatchewan was the backlash from the 2005 Offshore Accords signed with Newfoundland and Nova Scotia. The offshore arrangements were seen as unprincipled "one-offs" that compromised the integrity of the Equalization Program. Critics also called into question the resulting inequities among "have not" provinces.²¹⁵ Several provinces vocally criticized the Offshore Accords. Ontario, in particular, viewed the arrangements as direct financial blow to "have" provinces. Ontario Premier Dalton McGuinty points out that the Offshore Accords fundamentally reconstruct the fiscal arrangements of the country to the detriment of Ontario.²¹⁶ While Equalization is funded out of the general revenues of the federal government, the program is financed by the taxpayers of "have" provinces.

The third political consideration was the effect a Saskatchewan Energy Accord would have on the expectations of other provinces. Ottawa justified the Newfoundland and

Nova Scotia arrangements by the exceptional debt load and financial hardship of those provinces. If the federal government were to extend a special arrangement to Saskatchewan, it would open a *Pandora's Box* of Equalization demands.

In the months following the Offshore Accords, five provinces and one territory issued requests for a new Equalization arrangement. Demands included \$5 billion for Ontario;²¹⁷ protection for tourism and agriculture revenue in Prince Edward Island;²¹⁸ protection for diamond revenue in the North West Territories;²¹⁹ \$3 billion for Quebec;²²⁰ an increase in overall Equalization entitlements for New Brunswick;²²¹ and an Energy Accord for Saskatchewan. If the federal government bowed to Saskatchewan's Equalization demands, the other provinces would be sure to follow. Fearing a Saskatchewan Accord would result in the fragmentation of Equalization into twelve separate arrangements, the Martin Government declined to grant the province an Equalization agreement.

The Harper government faces a different set of political pressures. Due to the views of Harper and his close circle of advisors, the Conservatives are more likely to deliver a Saskatchewan Energy Accord or even extend Saskatchewan's demands to the entire program.²²² During the elections of 2004 and 2006 the Conservative Party platform included a promise to return to a ten-province standard and eliminate nonrenewable natural resources from the formula.²²³ However, political pressures may work against Saskatchewan's cause. Equalization is a highly controversial issue among provinces. In a minority government situation the Conservatives may be reluctant to pursue the divisive issue.

3.2 Saskatchewan

For the Saskatchewan government, the political motivations for pursuing an Energy Accord are straightforward. Once Courchene's paper became public, the government was forced to take action to recover clawbacks that exceeded 100 percent. After the federal government gave Saskatchewan first the \$120 million and then the \$367 million payments to compensate for the unfair clawbacks, the province decided to expand its Equalization battle by asking for an Energy Accord.

The public struggle that led to the signing of the 2005 Offshore Accords significantly boosted the popularity of Premiers Hamm and Williams. Calvert had an opportunity to create a similar wave of public support by staging a Saskatchewan Equalization fight. In particular, the timing and nature of the March 2004 Saskatchewan advertising campaign suggests that the government's focus was on building popularity as much as securing a new Equalization arrangement. The federal government responded quickly to the original Saskatchewan grievances prompted by Courchene's paper. The confiscatory clawback came to light in February 2004, and by the beginning of March the federal government had already offered a payment of compensation. Instead of continuing to work directly with Martin and Goodale to find a more long-term solution, the Saskatchewan government chose to run a newspaper campaign criticizing Ottawa for the province's Equalization problems. Such actions are usually reserved for mobilizing public pressure on an unwilling federal government. The federal government, however, seemed ready to negotiate. Therefore, it appears that Calvert was motivated by public support as much as Saskatchewan's Equalization concerns. Moreover, with a "bad news" budget scheduled to be delivered at the end of March,²²⁴ speculation arose that the ads were merely an attempt to distract the public in order to deflect blame for the budget.²²⁵

Then Finance Minister Van Mulligen offers an alternative explanation. He suggests that after the \$120 payment issued to Saskatchewan in March, there was a sense that the federal government was finished negotiating. While Ottawa referred to the payment as “interim,” Saskatchewan found no evidence to suggest that Ottawa was willing to take further action on the matter. Therefore, the ads were intended to keep the issue on the public agenda and in the priorities of the federal government.²²⁶

Regardless of the intent of the March ad campaign, popular support is crucial to the NDP government that has a majority of only two seats. Equalization is a popular cause. The Calvert Government built an all-party coalition to present its case to Ottawa and to its residents. It is difficult for the public to fault a government that is lobbying for the province’s “fair share.” The Equalization seems to have been an ideal opportunity for Lorne Calvert to earn some much-needed points in the popularity polls.

4. Conclusion

There are a few interesting points to highlight about the Saskatchewan case. In regards to the position of the Martin government, hindsight renders the Liberal reasoning inconsistent. Throughout the negotiations, Goodale and Martin insisted that the Equalization Program needed to be dealt with holistically. The appointment of the O’Brien panel was an attempt to find program-wide solutions. Goodale publicly stated that Ottawa was not willing to negotiate side deals. However, the February 2005 Offshore Accords are precisely the kind of “back of the envelope”²²⁷ arrangement that Goodale had previously rejected for Saskatchewan. This reversal seems to indicate that political factors – and not principled reasoning—were the predominant considerations

why Newfoundland and Nova Scotia received special treatment and Saskatchewan did not.

On the part of the Saskatchewan government, there are two interesting points. The first point is that Calvert actually increased his demands after Newfoundland and Nova Scotia got their Offshore Accords. Prior to February 2005, Calvert was merely seeking the correction of the elements of the formula that resulted in the confiscatory clawback (100 percent and higher). In addition, Saskatchewan wanted the extension of the Generic Solution to protect 30 percent of the province's oil and gas revenue. It emphasized the problems of the FPS (see section 1.1.1), the unfair effects of the Generic Solution (see section 1.1.2), and the problem of the disincentive (see section 1.1.3). At this point, all of Saskatchewan's demands could have been met by amendments inside the existing Equalization Program. After the Offshore Accords were signed, Saskatchewan added a new demand. The province now seeks a bilateral Energy Accord outside of the Equalization formula. The government has built an argument based on provincial equity (see section 1.1.4). The shift in focus is probably an attempt to maximize the benefits for Saskatchewan. It reflects a strategy based on pragmatism more than ideology or principles.

The final point to highlight about Saskatchewan is its strong reliance on the appeal for equity. Since the signing of the Atlantic Accords in 1985 and 1986, Saskatchewan's energy revenues had been receiving different treatment than those of Newfoundland and Nova Scotia. Instead of looking to correct this inequity, the federal government exacerbated it with the 2005 Offshore Accords. In terms of equity and federalism, Saskatchewan had little choice but to raise the issue and seek a return to fairness.²²⁸

Chapter 5: *Conclusion*

Equalization has become an essential element of federal provincial fiscal arrangements in Canada. Its importance has increased over the years so that it is now an integral part of the economic and social fabric of the country. In fact, its entrenchment in the Constitution in 1982 signaled its importance to the Canadian federation. Today, Canadians not only accept the principle of Equalization, they embrace it because it ensures all Canadians, regardless of where they live, can expect similar levels of services from their provincial governments. This provides a very significant contribution toward maintaining equity in our society.²²⁹

Equalization is not an ordinary federal program. It is a base for Canada's regime of fiscal federalism. However, the current Program seems to be in a state of disarray. The examination of the cases of Newfoundland, Nova Scotia, and Saskatchewan reveals many problems with Equalization. These cases highlight the cleavages among the provinces as well as the inadequacy of the current reform process. This chapter will take a final look at the positions, politics and processes that are found in the cases of Newfoundland, Nova Scotia and Saskatchewan. Several interesting observations can be made by comparing these cases. Finally, this chapter will examine the future of the Equalization Program for Newfoundland, Nova Scotia, and Saskatchewan, as well as for the rest of Canada.

1. Positions

There are several notable differences between the positions of Newfoundland and Nova Scotia on one hand, and Saskatchewan on the other. The most important difference relates to timing. Newfoundland and Nova Scotia have been fighting for control and retention of their offshore oil revenues since each province joined confederation. Newfoundland in particular views its Terms of Union as something unique from those of

the rest of the provinces. Newfoundland's Terms of Union included special protection of local industries from federal actions (Term 46), arrangements for Newfoundland the Newfoundland fishing industry (Term 22), and special provisions for offshore mining (Term 37), and special transfer payments (Term 23).²³⁰ Newfoundland has traditionally viewed its place in confederation as encompassing a kind of special circumstances by which differential treatment is required from the federal government. Newfoundland nationalism entered a new era with the election of Brian Peckford in 1979. Premier Peckford promoted nationalist sentiments based on cultural uniqueness and historic economic disadvantage.²³¹ This philosophy was highlighted in the negotiation of the 1985 and 1986 Atlantic Accords. These Accords demonstrate long-held commitment to protecting those provinces' energy revenues from the Equalization clawback. Once the offset provision (which provided payments to offset the clawback on offshore revenue) was nearing expiration in early 2000, Newfoundland and Nova Scotia revisited the same positions of the 1980s. Their positions remained consistent throughout the negotiation processes; both in the 1980s and in 2004-2005. In fact, during the negotiations leading up to the 2005 Offshore Accords, Premiers Williams and Hamm emphasized the purpose and intent of the original Atlantic Accords.²³²

Conversely, the Saskatchewan position has undergone several modifications since the 1980s. Saskatchewan's concerns date back to 1982 when the formula was changed from a five province standard to a ten province standard including 100 percent of natural resource revenue. Saskatchewan advocated a ten province standard with only 20 percent inclusion of natural resources (NAS-20 proposal).²³³ Saskatchewan maintained its preference for a ten province standard throughout the 1990s.²³⁴

Saskatchewan's focus first shifted shortly after the release of Thomas Courchene's paper in 2004. The province immediately adopted the position that clawbacks near or exceeding 100 percent were unfair. In addition, Saskatchewan sought the protection of 30 percent of its energy revenue (down from 80 percent that was advocated in the NAS-20 proposal of 1982).²³⁵

The Saskatchewan position shifted again immediately following the signing of the 2005 Offshore Accords. At this point, Saskatchewan began demanding its own energy accord with provisions similar to those attained by Newfoundland and Nova Scotia. Instead of settling for a 30 percent protection from the clawback, the province wanted to protect 100 percent of its oil and natural gas revenues.²³⁶

The inconsistency can be explained by the focus and motivation of Saskatchewan, Newfoundland and Nova Scotia. For the two Atlantic Provinces, the position was based on an unwavering principle that the provinces must be in control and benefit from their own resource industry. Saskatchewan, however, focused on matters of equity. It modified its positions to emphasize the disparate treatment between offshore oil and Saskatchewan's energy revenue.

The lack of consistency in Saskatchewan's position may also be explained by an emphasis on expediency rather than principle. While Newfoundland and Nova Scotia were deeply committed to the principles of their positions, Saskatchewan was willing to be flexible in order to reap the greatest benefit. At present, Saskatchewan's pragmatic positioning has not yielded the desired energy accord. Some political factors likely contributed to Saskatchewan's lack of success.

2. Politics

The federal government's electoral concerns were the most prominent political factor that influenced negotiations in the cases of Newfoundland, Nova Scotia and Saskatchewan. In the cases of Newfoundland and Nova Scotia, the basis of the Offshore Accords was formed during the June 5, 2004 phone call between Prime Minister Paul Martin and Premier Danny Williams in which the two purportedly reached a verbal agreement regarding Equalization and offshore oil. As explained in Chapter 3, the phone call occurred in the midst of a close federal election campaign. The federal Liberals had a significant electoral stake in the swing ridings in Newfoundland and Nova Scotia. Once the promises were made, Martin tried to distance himself from his commitment. Signing a bilateral agreement was not popular with the other provinces. Moreover, the "one off" approach was not the preferred method in dealing with the problems of the Equalization Program. However after significant prodding from Premiers Williams and Hamm, the federal government conceded to terms set out by Newfoundland and Nova Scotia. It did so, in part, because Liberal MPs from the two provinces faced significant pressure from their constituents with an election pending.²³⁷ The Liberal government had considerable interest invested in maintaining the favour of voters in Newfoundland and Nova Scotia.

By contrast, Saskatchewan did not offer the same kind of electoral enticement. The Liberals held only one seat in Saskatchewan—that of Finance Minister Ralph Goodale—and the party was relatively confident in the reelection of the minister.

Moreover, other provinces such as Manitoba, Ontario, New Brunswick, and Quebec were opposed to any more accords. Equalization is funded by the taxpayers of all provinces. Therefore, when one province increases its equalization entitlement, the increase is funded by the tax dollars of other provinces.

Saskatchewan's current Minister of Government Relations, Harry Van Mulligen suggests that Newfoundland and Nova Scotia's energy arrangements, and Saskatchewan's lack thereof, amount to a cold calculation for seats on the part of the federal Liberal government.²³⁸ If Van Mulligen's assessment is correct, then the formula-based approach was sacrificed for pure electoral calculations.

The federal Conservatives also faced electoral pressures. During the 2004 and 2006 federal election campaigns, the Conservative Party's election campaign included promises to eliminate nonrenewable natural resources from the Equalization formula and returning to a ten province standard. Moreover, the Conservative candidates from Saskatchewan made Equalization a cornerstone of their election campaign. Saskatchewan MP Tom Lukiwski called Equalization "the largest single [election] issue that people in Saskatchewan should be concerned about."²³⁹ However, during the Harper Government's first session, there was no move to implement the Equalization promises.

In June 2006, Harper became increasingly noncommittal about his government's Equalization intentions.²⁴⁰ In an interview with a Calgary radio station, Harper clarified that the fulfillment of his election promise was merely his *preference* and not a *guarantee*.²⁴¹ This is a clear departure from his former commitment to fix Saskatchewan's Equalization problems. Later that month, federal Finance Minister Jim

Flaherty stated that “The government of Canada has not taken a position on (how to fix equalization) and that continues to be our position now – that we haven’t taken one.”²⁴²

Regional political pressures undoubtedly contributed to the Harper government’s change of heart. In Harper’s words: my “government is trying to balance competing demands among provinces and quite frankly I don’t think the details of the technical calculations are of much interest to most people.”²⁴³ Harper’s reference to trying to balance demands was an acknowledgement that the Equalization commitments in the Conservative election platform have little support outside of Saskatchewan and Alberta.

Ontario vocally opposes any reforms that result in a cash infusion into the Equalization Program. Premier McGuinty points out that if the Equalization reforms proceed, Ontario stands to lose \$1 billion.²⁴⁴ Because Ontario has little nonrenewable natural resource revenue, the elimination of resources from the formula would elevate the province even further above the “have” line. As a result, Ontario taxpayers would be contributing an even greater proportion of money to the Program. Premier McGuinty has traveled Canada over the summer of 2006, trying to find allies for the Ontario position.²⁴⁵

Similarly, Quebec would stand to lose a portion of Equalization transfers should the Conservative proposal be implemented.²⁴⁶ Again, this phenomenon is due to the low portion of provincial revenue derived from nonrenewable natural resources. New Brunswick and Manitoba share similar circumstances. Harper stands to lose a significant portion of provincial support if he carries out his Equalization commitments. A *Leader Post* editorial describes the Prime Minister’s position as follows:

Harper might believe he can afford the price of upsetting the West on resources in favour of pleasing vote-rich Ontario and Quebec, but it will be the first major campaign promise broken by a man who insists Canadians can trust him.²⁴⁷

The Conservative government is in a difficult political position. The Conservative Party website still says “we will remove non-renewable natural resource revenue from the equalization formula”²⁴⁸ However, regional political demands may trump policy preference.

For Saskatchewan, the prospects of a satisfactory Equalization arrangement in the near future are diminishing. The 2006 annual Council of the Federation summer meeting was held July 26 to 28. The premiers attempted to come to consensus on Equalization reform and the fiscal imbalance in order to make a stronger case to the federal government. However, at the end of the meeting, there was still no agreement. Alberta Premier Ralph Klein noted that the provinces will likely never reach consensus when it comes to Equalization. Instead of producing a consensus the talks were pitting the provinces against one another.²⁴⁹ Premier Calvert downplayed the setback, pointing out that while it is preferable for the provinces to find a common position, ultimately all decisions made regarding Canada’s Equalization Program will be up to the federal government.²⁵⁰ However, if Harper’s resolve is in fact weakening, Saskatchewan has few allies in its Equalization battle. The political climate has shifted against Saskatchewan’s position.

3. Process

In the long run, the element of these cases that will prove the most important for Canada is the process by which the Equalization arrangements were negotiated. The Offshore Accords and the subsequent events have put considerable strain on the Canadian framework for fiscal federalism and regional sharing. As noted in previous chapters, the

Equalization Program has been traditionally renewed at five year intervals. There have been several occurrences of minor adjustments and interim amendments that have been made between renewals. However, none of these adjustments were as large or as controversial as those made in the February 2005 Offshore Accords.

The Offshore Accords were bilateral arrangements that dealt exclusively with Equalization provisions for two particular provinces. These were different from the 1986 and 1986 Atlantic Accords that focused on revenue sharing, jurisdiction, and control over the entire offshore industry. The 2005 arrangements specifically focused on Equalization. They fundamentally altered the makeup of the Program without consultation with the other provinces. Moreover, the Offshore Accords affect change outside the Equalization formula. Whereas all other provinces must accept the transfers as calculated by the formula, Newfoundland and Nova Scotia have obtained a completely separate side arrangement.

The process that led to the Offshore Accords, was highly ad hoc and arbitrary. The deals were initiated by a telephone promise in the midst of a difficult election campaign. The negotiations that ensued appeared to be motivated by expediency rather than principle. The Martin Government proceeded with the goal of minimizing the cost and size of the Offshore Accords. Newfoundland and Nova Scotia proceeded with the intention of securing the complete protection of all offshore revenues from the Equalization clawback. The result was an adversarial process that was driven more by electoral political concerns than by the Equalization formula.

This process departed from the tradition of amending the Equalization Program through changes in the formula that applies to all provinces equally. The federal

government's lack of respect for the long-term implications for the formula raises concerns about the future integrity of Equalization in Canada. Robin Boadway points out that the Offshore Accords will have undesirable future implications for fiscal federalism:

The idea of introducing special measures to help special provinces for particular ad hoc reasons sets [a] bad precedent. I think that the most recent deal that was struck with Newfoundland and Nova Scotia, whatever you may think of its benefits, was what really set the cat among the pigeons.... I think we have to get the process back to one where there's predictability, where it's driven by a formula, where decisions are taken with a long-term perspective in mind, and where we worry about the irreversibility of decisions that are taken for short-run expediency.²⁵¹

The reliance on ad hoc bilateral arrangements to deal with the complaints of individual provinces not only threatens the principles of the Equalization Program in the short term, it also opens the door to further degeneration of Canada's regime of regional sharing.

Professor Ronald Watts expresses his concerns as follows:

Once you get into ad hoc judgments there's no end to the special pleading that different governments will bring forth, and so on. And it seems to me that those agreements [the 2005 Offshore Accords] have raised the issue of special pleading by other provinces, arguing that they are now disadvantaged by those arrangements.²⁵²

The Offshore Accords set a dangerous precedent for future changes to Equalization.

Abandoning the formula-based inclusive approach leaves Equalization vulnerable to the whims of any province that gains political clout with the federal government. If this precedent prevails Canada's Equalization Program may lose the credibility that is required to continue facilitating a system of regional redistribution.

4. The Future of Equalization

4.1 Newfoundland & Nova Scotia

The Newfoundland and Nova Scotia 2005 Offshore Accords were signed with the Liberal federal government. With the election of Stephen Harper's Conservatives in

January 2006, the exact terms of the arrangements may be in jeopardy. In March 2006, federal Finance Minister Jim Flaherty suggested that the Newfoundland and Nova Scotia deals could be revoked.²⁵³ He pointed out that: “right now we have two equalization formulas that the previous government is firmly committed to.... We can’t be firmly committed to two [E]qualization programs.”²⁵⁴ However, since Flaherty made the above statements, a consensus seems to have been reached among governments regarding future of the 2005 Offshore Accords. Even Flaherty changed his tune saying that “media reports suggest that the government is considering scrapping the offshore agreements reached last year with Nova Scotia and Newfoundland and Labrador... This is both factually incorrect and misleading.”²⁵⁵ The current federal position supports the maintenance of the Offshore Accords.²⁵⁶ However, the sentiments from Ottawa indicates that while the Newfoundland and Nova Scotia agreements will be tolerated, extra-formula arrangements are not in store for the future.

4.2 Saskatchewan

Unlike Newfoundland and Nova Scotia, Saskatchewan does not have a signed energy agreement with the federal government. Moreover, the present political climate is not conducive to a Saskatchewan Accord. The biggest obstacle Saskatchewan faces is the unfavorable chronology of events. When Newfoundland and Nova Scotia signed their Accords with the federal government in 2005, there were no pre-existing Equalization deals under the scrutiny of the rest of the country. While the negotiation of the Offshore Accords drew the objections of several provinces—most notably Ontario—it was not until after the Newfoundland and Nova Scotia agreements were signed that Equalization became a primary focus for the entire country. For the most part, the Offshore Accords

received a negative response from the provinces. With the exception of Saskatchewan, which wanted to use the Accords as a basis for negotiating its own energy agreement, the provinces viewed the Newfoundland and Nova Scotia arrangements as a threat to the Equalization Program.²⁵⁷ The Martin government endured much criticism from opposition federal parties, provincial governments, media, and academics for the process that led to the Offshore Accords. While the Harper Government has promised to maintain the Newfoundland and Nova Scotia deals, it seems less willing to participate in the political maneuvering that would be involved in negotiating a Saskatchewan Accord.

Aside from negotiating a bilateral energy agreement with the federal government, Saskatchewan's alternative strategy involves lobbying to remove nonrenewable natural resources from the Equalization Program and returning to a ten province standard. The combined effect of these two amendments would be equivalent to an energy accord for Saskatchewan because it would remove oil and natural gas revenues from the formula, thereby eliminating the clawback. While Stephen Harper maintains that his preference is to act on these amendments, the realities of leading a minority government may make this difficult.

Further impairing Saskatchewan's case is the discord among the provinces on the matter of Equalization. Between 2004 and 2006 the Premiers have met several times to discuss Equalization. At the Council of the Federation meeting in July 2006, the premiers finally conceded that a consensus is unattainable. A *Leader Post* article summarized the negotiations: "It was Mission: Impossible from the beginning – even Tom Cruise couldn't have pulled the provincial premiers into a unified fighting force on Equalization."²⁵⁸ Newfoundland Premier Danny Williams conceded that the opportunity

to find agreement had passed: “those irreconcilable differences just can’t be reconciled.”²⁵⁹ Even more divisive are allegations that Quebec has deliberately sabotaged the Equalization discussions. Following the Council of the Federation meeting, an Ontario official accused Quebec of playing political games. The official suggested that Premier Jean Charest preferred to negotiate with the Prime Minister without the rest of the provinces.²⁶⁰

With the high degree of discord among provinces, Prime Minister Harper has a difficult task in finding an acceptable solution for the Equalization Program conundrum. In the end, Saskatchewan’s only major ally is Alberta—which would like to see nonrenewable resources excluded in order to keep the overall costs of the Equalization Program lower.²⁶¹ In fact, Premier Klein declared that Alberta would no longer participate in the Equalization Program if its energy resources were included in the program.²⁶² Klein and Calvert insist that Harper must keep his promise to exclude natural resources.²⁶³ However, Alberta’s support may not be enough for Saskatchewan to sell its case to the federal government. At present, the prospect of a Saskatchewan Accord or equivalent amendments to the Equalization Program, is precarious at best.

4.3 The Equalization Program

Most governments agree that the process and substance of the 2005 Offshore Accords were an aberration that should not be repeated. However, Canadian governments must deal with the Equalization Program that remains following the implementation of the Offshore Accords. Conservative MP Judy Wasylycia-Leis poses an important question:

Given the fact that bad deals were struck with Newfoundland and Nova Scotia, how do you handle this situation before we get to the point where we have to sit down again and figure out a new program with a new formula.... How do we handle it now

so that we can avoid everything coming undone to the point where there is nothing left to fix?²⁶⁴

All governments recognize that the Equalization Program is inadequate in its current configuration. Reforming the Program is on the immediate national agenda. However, Equalization—along with the closely related issues of regional sharing and the fiscal imbalance—is one of the most divisive issues in Canada at present. The process of Equalization reform faced many roadblocks. Every time a solution is crafted that satisfies the demands of one province, several new problems are created for others.

In the past, the federal government has often imposed amendments and reforms notwithstanding provincial objections. Saskatchewan is currently pushing Harper's government to do just that. Premier Calvert has repeatedly emphasized that in the end, it does not matter what his provincial and territorial counterparts think, Equalization reform falls to the federal government.²⁶⁵ However, the minority Conservative government must consider the political implications of any decision it makes. Thomas Courchene highlights Harper's dilemma in the following sentences:

Even though equalization is a federal program, Mr. Harper cannot afford to ruffle too many feathers in Ontario and Quebec, where his support is most tenuous. Nor can he afford to alienate his base in Alberta, which steadfastly opposes the direct use of resource revenues to fund equalization.²⁶⁶

In the past, both the Martin and the Harper governments were able to postpone dealing with the issue under the pretext of waiting for the report of the O'Brien Expert Panel on Equalization and Territorial Formula Financing. Now that O'Brien has released his findings (May 2006), Stephen Harper will be forced to address Equalization come the fall 2006 sitting of the House.

The federal government's political options are limited. Harper must maintain the Equalization formula while still satisfying the demands of the provinces. Perhaps the best compromise would involve a page from every province's wish list. First, the five province standard would be replaced by a ten province standard. This would eliminate the inequitable treatment between standard and non-standard provinces as well as project a more realistic standard for the measurement of fiscal capacity.

Second, the rate of inclusion for nonrenewable natural resources would be reduced to 50 percent. Chapter 2 discusses why including 100 percent of nonrenewable resources in the Equalization formula creates problems of perverse incentives and confiscatory clawbacks. However, completely eliminating these revenue sources from Equalization would significantly decrease the effectiveness of the Program. Many provincial governments generate significant revenue from natural resources. For example, in the 2005-2006 Saskatchewan budget estimates nonrenewable natural resources comprised nearly a quarter of the province's own source revenue.²⁶⁷ Therefore, if these resources are not measured at all the effectiveness of Equalization will be endangered. The Constitution states that the purpose of Equalization is to "ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."²⁶⁸ Since 1967, Canada's Equalization Program has sought to fulfill this purpose by equalizing the fiscal capacity of the provinces by way of the RTS approach. However, it would be impossible to measure and equalize fiscal capacities if a significant portion of this capacity. Therefore, it is better to deal with the problems created by nonrenewable natural resources by including them at a rate of 50 percent as opposed to eliminating them entirely. Moreover,

the results of including 100 percent of natural resources paired with a ten province standard would increase the total cost of the Equalization Program unacceptably (by allowing all of Alberta's oil and natural gas revenues to enter the formula).²⁶⁹ If Equalization transfers were increased to adopt 100 percent inclusion of natural resources, Ontario's fears that the cost of the entire program would increase would be realized. However, if Equalization reverts back to a ten province standard with 100 percent inclusion of natural resources, Ontario would become a "have not" province. Historically, this condition was deemed unacceptable and the Program was amended to ameliorate the situation. Instead, only including half of nonrenewable resources will control the overall cost of the Program and avoid making Ontario an Equalization recipient.

Both of the above amendments are recommended in the Expert Panel on Equalization and Territorial Financing final report entitled: *Achieving a National Purpose: Putting Equalization Back on Track*.²⁷⁰ Should these recommendations be implemented, no single province would be happy with the outcome. However, if it were indeed impossible to find accord among the provinces, perhaps if every province were a little unhappy, then the right balance would have been struck. More importantly, these amendments do not create any significant losers. In other words, no province stands to lose a large proportion of their current Equalization transfer under the proposed regime. The following table demonstrates the effects that the amendments would have on each province:

Formula to Formula Comparison for 2007-2008
\$million

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
Current Formula	587	282	1,363	1,417	6,273	0	1,720	0	0	35

New Formula	482	286	1,462	1,462	6,926	0	1,789	156	0	0
Changes	-105	4	99	45	653	0	69	156	0	-35

Source: Expert Panel on Equalization and Territorial Formula Financing, *Achieving a National Purpose: Putting Equalization Back on Track*, Ottawa: Government of Canada, 16.

These results would make it appear that Newfoundland would lose considerable funding. However, these calculations use the numbers included in the Equalization formula. The effects of the 2005 Offshore Accords are not considered. Therefore, if the Newfoundland and Nova Scotia arrangements are indeed upheld, Newfoundland's projected losses under the proposed formula would be recovered by offset payments under the Offshore Accords.

The Offshore Accords are an annoyance that appear to be a fact of Canadian Equalization for the next ten to twelve years. However, it is important not to allow this unfortunate condition to lead to the complete abandonment of the Equalization process. Should Equalization be allowed to disintegrate, the ties that bind the provinces together into one fiscal and social union will begin to break down. Equalization is a program that is not *comme les autres*. This fact was verified in 1982 when Equalization was entrenched into the Canadian constitution. Indeed, Equalization personifies a commitment to fairness, sharing and respect. Equalization is a pan-Canadian pledge to the idea of a national social citizenship. Consequently, when Equalization is not functioning, an element of Canadian citizenship is endangered.

Since 2004, governments have not treated Equalization with the care and respect that the program demands. Political considerations and federal frugality have resulted in program alternations that are eroding the efficacy of Equalization. Year-to-year changes to Equalization have been implemented through the budgetary process without any

adequate consideration of long-term impacts.²⁷¹ Richard Bird articulates the exigency of the matter: “It has been said, and it is true to some extent, that equalization is the glue that holds the country together. Improperly used, pushed too far, the glue may turn into a solvent. That’s what we are afraid of.”²⁷² If Equalization is allowed to deteriorate beyond repair, the repercussions will affect the very core of Canadian values and unity.

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Chapter 2

¹² Rising energy revenues does not affect Alberta's place in the Equalization program because Alberta no longer receives transfers under the program.

¹³ Originally, all ten provinces determined the national standard. However, as Alberta's energy revenues pushed the standard higher, the program costs expanded. Eventually, Alberta's influence on the standard would have rendered Ontario a "have not" province. To remedy the uncontrollable costs, the federal government switched to the FPS. The FPS excluded the richest province (Alberta) and the poorest provinces (Atlantic Provinces).

¹⁴ The alternative to a formula-driven equalization system, is a macro-approach. A macro program would use some kind of grand indicator, such as provincial GDP, to determine the overall fiscal capacity. The macro approach eliminates the unintentional consequences that will inevitably arise in a formula-based program. However, proponents of RTS point out that a macro program would not adequately serve the core function of providing comparable services and comparable taxation levels.

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²¹ Section 125 states: "No Lands or Property belonging to Canada or any Province shall be liable to Taxation."

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Chapter 3

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Chapter 5

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